Bank Reform in the UK

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Bank Reform in the UK: Part I – The Future of Banking Commission

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I. Responding to the crisis

The banking crisis led to a range of domestic and international inquiries, agreements and reforms too numerous to absorb. Not surprisingly, it is on the domestic front that most of the significant change has occurred. This article and its companion look at two different sets of proposals for the reform of UK banking and its regulation. The first article concentrates on an independent report, initiated by the Which? consumer organisation, that looks at the crisis primarily as an opportunity to reshape banking around customer satisfaction. The second article discusses the more mainstream approach of the government’s proposals, which lean to a characterisation of the problem that focuses on regulation, although the article also touches on the Independent Banking Commission (IBC), which has been established to consider many of the same issues that were discussed by the Which? inquiry.

An upside of the crisis seemed to be that it might bring some unity of purpose across the world, if only over finance. Government leaders reached important agreements on additional funding for the IMF and various other measures. They also promised coherent reforms to bank regulation, but relatively little concerted action has followed: there were some changes in the international regulatory architecture, including the establishment of the Financial Stability Board to monitor global risk, and modification of the capital adequacy rules (Basel III). Issues of domestic politics and competitive advantage prevented expressions of intent from fully translating into new rules and practice. This did not mean governments were not keen to take action against the banking industry, but in many cases proposals for reform were caught between the need to be seen to be doing something and nervousness about the impact of change on a fragile domestic financial industry. As a result, the focus tended to rest on the rescue of the sector, while problems remained ill defined and reforms rather insipid.

In the UK, before losing office, the Labour government had resisted calls to dismantle the regulatory structure established by the Financial Services and Markets Act 2000 and based around the Financial Services Authority (FSA) and the tripartite system, which connected the FSA, the Bank of England and H.M. Treasury. After all, this structure had been a major part of the economic reforms introduced by the Prime Minister, Gordon Brown, when Chancellor of the Exchequer. Some new rules were introduced and the FSA altered its approach to supervision. The Banking Act 2009 formalised the Bank of England’s role in protecting and enhancing the stability of the UK’s financial system and obliging it to work with other ‘relevant bodies’, including the FSA and the Treasury. The act established the Financial Stability Committee within the Bank, although there was a lack of clarity about its role and its relationship with the FSA. The Financial Services Act 2010 made financial stability one of the FSA’s regulatory objectives. It also empowered the Treasury to make regulations regarding executives’ pay and required the FSA to introduce rules obliging all authorised firms to have a remuneration policy. This was a response to the popular outcry that had assumed a simplistic link between high pay and the crisis, but which, if not addressed, threatened to make a weakened government even more vulnerable. In addition, the act required the FSA to ensure authorised firms have both an appropriate recovery plan to allow their business to continue in the event of specified circumstances and a resolution plan regarding action to be taken in the event that the firm fails, or is likely to fail. Finally, there were new rules

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1 Communiqué from the London summit (Apr. 2009) <tinyurl.com/cb0noe>.
3 House of Lords Select Committee on Economic Affairs, n. 2, 32.
4 Financial Services Act 2010, s. 1. There is also an amendment relating to public understanding of financial matters: s. 2.
5 Ibid., ss. 4-6. This followed the report by Sir David Walker: A review of corporate governance in UK banks and other financial industry entities (London, The Walker Review Secretariat, 2009). Rules on remuneration are also flowing from the EU’s Committee of European Banking Supervisors.
on the FSAs disciplinary powers, consumer redress and the compensation scheme.  

Changes were made to the tripartite system, including a clearer distinction between normal and crisis conditions, better information flow, earlier involvement of the Bank, improved public communication during a crisis, and the allocation of sufficient resources. The FSA was aware that its future was under threat – indeed, for many the fact of the crisis was proof of incompetence and justified its abolition. Nevertheless, it has done what it could to ensure its survival. Lord Turner, chair of the FSA, undertook a broad-ranging review, acknowledging flaws in supervisory practice and recommending internal changes alongside tougher rules on capital adequacy and liquidity. Shortly before the crisis broke the FSA had rolled out a principles-based approach to regulation. With justification, Lord Turner suggested that this change had been encouraged – perhaps, prompted – by political pressure, but in any event the crisis brought a re-think, signalled by the warning from its chief executive, Hector Sants, that bankers should be ‘very frightened of the FSA’, and by a rise in the number of high profile disciplinary proceedings and criminal prosecutions.

So, this first wave of reform in the UK rearticulated bank supervision without really altering its architecture or changing the structure of the banks. Yet, there was growing support for a more drastic programme of reform. In part, this may have been because it allowed opposition parties to reinforce criticism of the government by arguing that dramatic changes to regulation after the 1997 election – removing the Bank of England and establishing a single regulator – contributed to the problems of the financial sector. The call for reform was not confined to the political arena, it was also at the core of the report produced by the Future of Banking Commission (FBC). This inquiry was established in December 2009 by the consumer organisation, Which? Its membership was drawn from the main political parties, with David Davis (Conservative) as chair, John McFall (now Lord McFall, Labour), who had chaired the Commons Treasury Committee, and Vince Cable, who as Liberal-Democrat economic spokesperson was seen as something of a fresh breeze by many in the City during the run up to the 2010 election and who became Business Secretary in the Coalition government. In addition, there were three commissioners associated with the City (David Pitt-Watson, Roger Bootle and Philip Augar), Clare Spottiswoode, who among other things, chaired Ofgas in the 1990s and later became a member of the IBC, and Peter Vicary-Smith from Which?

Which? saw the crisis as an opportunity to re-examine the structure of banking – and to a lesser extent its regulation. The aim of the commission was not, therefore, primarily to respond to the crisis. This made it rather different from the slew of other inquiries: it was concerned less with questions relating to bank solvency and more with the systemic problems in a sector that had, for a long time before the crisis, failed to deliver for its customers or for society at large. The other novel feature of the commission was that it purported to draw on, and reflect the experience of, ordinary customers and to this end encouraged, not the usual responses to set questions that are a normal feature of such inquiries, but engagement through email submission and public meetings, even if the bulk of those who appeared in person were from the industry, regulators or representative organisations.

2. Broken banking

The purpose of the commission was:

‘To establish a reformed banking system that serves the needs of ordinary people and the wider interests of society.’ It sought ‘to map out the path towards a sustainable culture, structure and regulatory landscape for the banking industry.’

‘But the larger aim is to create a stable yet competitive banking industry, where the interests of consumers and businesses are aligned with those of banking executives and shareholders, and where banks can be allowed to fail without risking the stability of the wider economy.’

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6 Financial Services Act 2010, s. 7.
7 Ibid., ss. 8, 9-13, 14, 16-17.
8 Financial stability and depositor protection, n.2, para. 7.9 et seq.
10 Principles-based regulation: focusing on the outcomes that matter (FSA, 2007).
11 See speeches by Gordon Brown and Tony Blair: CBI interactive conference, 28 November 2005 (<tinyurl.com/p6ehyp>) and University College London, 26 May 2005 (<www.number10.gov.uk/Page7562>);
12 Reuters newsmakers, 12 March 2009 at <tinyurl.com/kw9r5l>.
13 See <tinyurl.com/358zarz>
14 Future of Banking Commission, 2 September 2010, p. 6; <commission.bhbb.org/banking>.
15 Ibid., p. 78.
16 Ibid., p. 20.
17 Ibid.
The commission’s ‘core beliefs’ were that banking matters, that the industry has fundamental problems, that current banking reform will not solve them and that a new approach is required that recognises why banking is different.18

The report starts with the assertion that banks are unlike other businesses in so far as they undertake certain functions that are vital to a modern economy:19 the facilitation of payment; the bringing together of savers and borrowers; and the management of risk through both the pooling of deposits and the diversification of risk by lending to different borrowers. This explains the need to rescue banks during the crisis and justifies intervention in how they run their businesses. But it is argued that over the decade or so before the crisis banks moved from these functions to new financial techniques, such as securitisation, which allowed the expansion of lending without a concomitant increase in capital; indeed, an important objective of securitisation was to reduce the regulatory capital a bank was obliged to hold by removing assets from the balance sheet. Investment banking became entangled with retail banking, so that when these new financial techniques got into difficulties government was unable to distinguish the two facets of banking and was obliged to save both.

Along with these developments it is claimed that there came a change of culture within banks that acted to the detriment of customers. The drive for profits swept aside concern for customers and became embedded in remuneration policies that rewarded staff, not for good service and customer satisfaction, but for taking excessive risks and selling unsuitable products, such as mortgages to those who could not afford them and payment protection insurance to those who could not claim on them. On this view, the crisis arose from a fundamental problem that had gone untreated for many years. Disgruntled customers knew something was wrong, but their complaints were dismissed or treated as one-offs rather than as evidence of a structural flaw because the importance of the industry to the economy meant it had a political significance which discouraged intervention. This analysis led the commission to argue for a return – more-or-less – to traditional banking, that is, to banking as it was before infected by the perversions of modern finance: banking that focuses on the needs of customers.

3. Breaking-up banks

How is this transformation to be achieved? The proposals concentrate on establishing a more efficient market that meets customer needs by facilitating competition and so ‘delivers benefits for those the banks are there to serve’.20 The main obstacle to competition is seen as the encouragement given to banks to grow by the implicit government support for those seen as too big to be allowed to fail. This has led to a narrowing of the retail banking market through mergers and acquisitions and the expansion of retail banks into investment banking. The commission believes that breaking up the banks will protect customers by providing better competition and by removing the risky financial techniques and culture of investment banking, which will return retail banks to the purity of deposit-taking, lending and payment. The commission also favours the establishment of narrow or limited purpose banks alongside ordinary retail banks. These would be designed for those wary of taking any risk. Such banks would be restricted as to the investments they could make and their deposits would be 100% guaranteed.21

Breaking up banks has proved controversial – endorsed by Mervyn King,22 but rejected by Alistair Darling when he was Chancellor. It certainly brings problems. There is the difficulty of defining retail and investment banking with sufficient precision to prise them apart or even to separate them in a more limited way by, for instance, some form of Chinese Wall. In any case, the financial sector as a whole is integrated: Lehman Brothers and Northern Rock were, after all, narrowly focused banks. There would be a loss of synergy and efficiency. It would be difficult for a country to act alone in disaggregating banks for fear that they would simply move parts of their business abroad. While it is very unlikely that a major bank would move from the US, the UK is not in such a comfortable position, particularly as the BRIC countries flex their financial muscles. The removal of banks would not affect retail branch networks in the UK, but the loss of the head office and of investment banking capacity would have an impact on jobs, spending, tax revenue, and the UK’s position as both a financial centre and a place in which to invest.23 Finally, there is the issue of credit and the health of pure retail banking. Retail banks are not particularly strong: their balance sheets are full of loans secured against assets whose value is uncertain or has significantly deteriorated; the inflow of

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18 Ibid., p. 12.
19 Ibid., chapter 1.
20 Ibid., p. 6.
21 One form of limited purpose banking would allow investment in mutual funds that issue shares so all lending would be entirely backed by equity; but this would mean the investments would be less liquid than ordinary bank deposits.
funds from repaid or refinanced loans has slowed as borrowers struggle; the interbank market remains difficult, particularly for smaller banks; and the return to profit of some banks appears to have been fuelled largely by trading activities, in other words, by investment banking. It is hard to see how retail banks will survive. At the very least they will have to return to charging account holders.

Nevertheless, in the wake of the crisis the idea of breaking up banks did acquire significant momentum, both before and after the General Election, and the issue has been expressly referred to the IBC. Recently, however, the banks have adopted what seems a more confrontational approach. In July 2009, Dr Vince Cable wrote in *The Times*, under the heading, ‘We’re the masters of the banking universe’:

‘What must be clear is that if the directors of Barclays Capital, or its equivalent, want their bank to become the world’s largest casino that’s up to them, but only if there is no question of the British taxpayer guaranteeing it.’

The following year, Lord Mandelson, Labour’s Business Secretary, referred to the head of Barclays Capital, Bob Diamond, as ‘the unacceptable face of banking’, following reports of his remuneration package, which George Osborne, shadow Chancellor, said ‘beggared belief’. Yet, in September 2010, Diamond was appointed Barclays’ group chief executive, Cable, who was now Business Secretary, observed, ‘It isn’t my job to appoint the head of a private bank.’ But he could not resist adding that the appointment raised ‘the policy question about how banks can be made safe, and we are worried about this combination of the casinos and the traditional banks.’ More colourfully, Lord Oakeshott, Treasury spokesperson for the Liberal-Democrats, accused Barclays of ‘sticking two fingers up at the government’. Clearly, disaggregation was in Cable’s mind, but by this time the matter had been passed to the IBC.

A couple of days later, without naming Cable, Diamond wrote in *The Independent*, ‘we’re the masters of the banking universe’:

‘What must be clear is that if the directors of Barclays Capital, or its equivalent, want their bank to become the world’s largest casino that’s up to them, but only if there is no question of the British taxpayer guaranteeing it.’

The FBC supported Sir David Walker’s report (2009) on corporate governance, but felt it did not go far enough. As has been seen, the commission’s view is that a culture has developed within banks which means they fail to consider the best interests of the customers, the shareholder or the financial system. The report wants greater attention to these issues, but is less clear on who should be their advocate, how they are to be defined and how they relate to directors’ duty to the company under the Companies Act? The commission says that directors – and particularly, independent directors – should be obliged to consider the effect of bank’s activities on the stability of the financial system, even if this conflicts with shareholders’ interests, and non-executive directors should be more willing to challenge the board. At present, directors are under a duty to consider the interests of the company, even if among the various factors they must take into account in fulfilling this obligation is the impact of decisions on the community and the environment.

4. Bank governance

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27 Financial Times, 8 Sept. 2010.
30 Guardian, 12 Sept. 2010 at <tinyurl.com/328rllz>.
The difficulties of trying to pursue the public interest within a private interest model of company law in the way the commission suggests are revealed by the UK Financial Investments Ltd, the company that holds the government’s bank shares. It is required to ‘manage these shareholdings commercially to create and protect value for the taxpayer as shareholder’, and this is defined in terms of eventually selling the shares to private investors, who ‘will depend on their confidence that the banks are being managed to create value for shareholders.’

The commission argues that the interests of the main shareholders – pension funds, insurance companies and so forth – are distorted because those who manage these assets are paid on the basis of short-term goals, such as share price. The report discusses the Stewardship Code, which was issued in July 2010 by the Financial Reporting Council following the Walker report, but is somewhat sceptical about its effectiveness, if only because its predecessor was never properly implemented. The commission, therefore, argues that the code should be mandatory and not left on a ‘comply or explain’ basis, which would allow opt outs. The report also recommends a larger role for auditors, who should be ‘a foundation stone for the integrity of our capital markets’, and, along with shareholders, independent directors and regulators, should ‘monitor and control bank behaviour’. Accounting principles should ensure that auditors are guided by the spirit and not merely the letter of accounting rules, and accounts should reflect real profits and expected losses. This echoes broader criticism by the commission (and others, including the FSA itself) of the tick-box culture, which simply requires adherence to rules, but how these proposals might work in practice is unclear. The wish for greater flexibility brings the danger of auditors, who will still be paid by the banks, working to the ‘wrong’ principles, and of the loss of consistency, predictability and fairness.

In respect of the winding-down of failing banks, the report argues that in order to reach the situation where banks can fail without threatening the financial system or the security of depositors, there must be a proper mechanism for allowing them to be dismantled. The proposals go beyond the recovery plan set out in the Financial Services Act 2010, and, in particular, there would be a requirement to ring-fence deposit-taking, lending and payment activities and for the bank to publish a document setting out plans for the treatment of customers in the event of a collapse.

The report suggests that pay should be linked to customer satisfaction, although the means of definition and measurement are left unclear. Finally, the commission implicitly questions the effectiveness of the FSA’s fit and proper persons criteria by proposing the creation of a banking profession rooted in appropriate qualifications and a code of conduct, which, like the systems in the legal and medical professions, would allow the imposition of penalties. It is certainly interesting that banks, which, typically, oblige their junior employees to obtain certain training qualifications, such as provided by the ifs School of Finance, have not always been so rigorous when appointing senior staff because they seem to have assumed that at this level banks are exactly like other businesses.

5. Bank regulation

The commission argues that, while regulation is limited in what it can achieve, the effect of the complex system developed by the Financial Services and Markets Act 2000 and the FSA freed banks from a sense of responsibility for their own conduct, allowing them to concentrate on short-term objectives without giving much consideration to long-term risk. The banks came to regard their only duty as being to comply with the rules and this led them to see avoiding those rules – by, for instance, using securitisation to remove assets from the balance sheet – as a legitimate goal without giving sufficient consideration to the long-term risk involved. The commission believes this attitude was reinforced by the implicit guarantee enjoyed by larger banks, which were regarded as too big to be allowed to fail, and that it encouraged, and was encouraged by, the culture among bank staff of placing short-term gain above customer satisfaction.

Lord Turner, in his review of the FSA, acknowledged that it had been at fault for making certain assumptions, which did not prove entirely correct: that markets generally adjust themselves and market discipline is more effective in ensuring firms have sound practices than regulation; that primary responsibility for managing risk rests with the banks themselves; that consumers are more effectively protected, not by product regulation, but by ensuring free markets and

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38 Future of Banking Commission, n. 14 above, p. 69.
39 Financial Services and Markets Act 2000, ss. 59, 64, sch. 6, para. 5; Financial Services Authority, Handbook, COND 2.5, Statements of Principle for Approved Persons, and Fit and Proper Test for Approved Persons (FIT).
40 Lord Turner, The Turner Review, n. 9 above.
that firms conduct their business appropriately. These assumptions led the FSA to focus on individual firms and processes rather than the whole system, and on the probity of individuals to the exclusion of concern about their technical ability. In the commission’s view the problem was not that these assumptions were necessarily wrong, but that they required a properly competitive market, which did not exist in retail banking. One of the report’s key themes involves the creation of an efficient market through enabling competition: ‘Regulators cannot replace the rigours of effective market discipline.’\textsuperscript{41} To this end it is asserted that competition should become one of the statutory objectives in the Financial Services and Markets Act 2000.\textsuperscript{42} However, the commission concludes that the nature of banking means competition must be supplemented by regulation. Here, while accepting Lord Turner’s analysis, the report recommends the replacement of the FSA.

The structure, which the commission favours and which has some resemblance to that later proposed by the Treasury, would comprise three agencies. The first would be the systemic regulator, which would monitor innovation and behaviour in the markets as a whole in order to prevent contagion, but without stifling development. It is hard to see how a regulator would be able to recognise when the inevitable risk that innovation brings becomes too great or to resist the accusation that it is holding back economic progress when it steps in. The second agency would be the prudential regulator, which would concentrate on facilitating the market rather than capital adequacy. The third agency would be concerned with consumer protection, but instead of focusing primarily on conduct of business, as the FSA has done, it would try to establish a competitive market so that consumers could make real choices. This proposal does not indicate how the Bank of England and the Treasury would be incorporated, how information would flow between these institutions and all of these new regulators, and how any actions requiring the involvement of all of them might be coordinated. It seems hard to escape the conclusion that the tripartite system, which sought to resolve this problem and which has been roundly criticised as inadequate, would need to be reinvented, and this time it might be even more complex. As will be argued in the next part, it also ignores the fact that banks in countries with very different regulatory structure failed and that, to quote Mervyn King, governor of the Bank of England, the problem was not so much the structure of the regulatory system, but that the regulators were, like the banks, ‘in the grip of a “flawed intellectual model”’.\textsuperscript{43} Doubtless, it is worth discussing how the regulator might guard against a future crisis, but redesigning the structure may merely divert attention from this issue and, indeed, create the danger that it will never be confronted because it is assumed that replacing the FSA resolves the problem.

6. The new banking

One of the principal strengths of the report is its emphasis on consumers and their experience, which have been largely absent from other inquiries. But this may also be one of its weaknesses. Much of the report generalises about the experiences of customers in a way that does not necessarily reflect their diversity. The impression is given that customers share a view of banking and its history according to which the desire for short-term gain led to a pernicious shift from banks providing excellent fact-to-face service to a situation in which customers are seen merely as pawns to be plucked – not considered or consulted. The problem for the commission was that depending on customers coming forward to report their experiences meant its gathering of opinion was rather unscientific. But it is also hard to gauge how representative the respondents were since there is little sense in the report of their characteristics, such as age, class, gender or ethnicity – and what of the 800,000 people who have no bank accounts?

The commission’s evidence for its conclusions derives from customers’ criticisms concerning product choice, selling methods and the quality of response to complaints. While not disputing the reality of such criticisms, they may not provide a rounded picture. In a world in which we are swamped by companies trying to sell us things, many (most?) customers may be utterly indifferent to banks doing the same thing and, while poor customer care is hardly to be applauded, it is not clear why it should be used as justification for structural change in banks and not in, say, companies supplying internet service. The report is imbued with a particular view of what retail banking should look like, and at its core is the idea of human contact. This is, however, becoming expensive to deliver and limits the possibility of new entrants to the market, unless they are offered the rare opportunity taken by Santander to buy from ailing banks. Completely new firms that are being encouraged into the market to set up new branch banking businesses, such as Metro Bank, may struggle

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41 Future of Banking Commission, n. 14 above, p. 37.
42 S. 2(2). In discharging its functions, the FSA is required to have regard to ‘the desirability of facilitating competition’ (s. 2(3)). The suggestion that the FSA should take a role in promoting competition was originally advanced by the Cruickshank report: D. Cruickshank, Competition in UK banking: a report to the Chancellor of the Exchequer (2 Sept. 2010), p. 317: <tinyurl.com/3ydh6tw>.
43 Future of Banking Commission, n. 14 above, p. 18.
to have a large impact. Yet, is branch banking what people really care about, or do they merely want easy access to a fairly limited range of services, which are provided through a variety of other platforms?

There may be something of a golden-age myth being constructed here. Some 25 or 30 years ago, retail banking was more of a face-to-face business which focused on the ‘traditional’ core businesses of deposit-taking, lending and payment services, but this did not mean it met customer needs. By the 1970s most people had bank accounts (a significant minority did not), but many of these were opened as a matter of convenience for employers, who were shifting away from cash wages, and they were only used for access to payment services. Banks remained forbidding places and credit difficult to obtain. There has been a shift from this face-to-face service to service delivered when and where it is required by the customer – through the telephone, the internet and card machines. Free banking replaced the system of paying for each line on a bank statement, which had been one way of funding retail banking and which would, presumably, return with the disaggregation of banks and the discouragement of product selling. There has also been a more relaxed attitude to credit with less reliance on an application made in person and more on impersonal granting of credit through credit cards and overdrafts. The bank manager’s role – and power – has been replaced by a more-or-less automated system based on factors such as credit scoring. This is not to say that such changes have not brought their own problems and irritations: excessive levels of credit; the shift from branches as semi-autonomous sovereign states to mere satellites of head office has made it difficult to get access to someone with sufficient authority in the event that things go wrong; the frustrations that can be involved in dealing with call centres; and the difficulties posed when a person’s profile does not fit the automated system. Nevertheless, threats to these services have brought criticism and problems, such as the row over bank charges on overdrawn accounts. In spite of their criticisms of the new banking, many might be rather reluctant to return to ‘traditional’ banking. This also reinforces the need for caution before damning financial techniques, such as securitisation, without considering their role in achieving social objectives, such as home ownership: to some extent the report is guilty of blaming the techniques rather than the ways they were used. The report flattens out customers without considering the effect of differences between them. The needs of a private customer are different from those of a business, and the needs of the poor customer or small business are different from those of the rich person or multinational. The tendency to focus on the experience of the private customer lends false credibility to the idea that banking is inherently simple and can easily be returned to the simplicity of some unidentified era. Life in the past often seems simpler, more innocent, but rarely was, or, at least, things are never quite that … simple.

44 Metro Bank has four ‘stores’ and projects to have 200 by 2020.
45 In part, (but only in part), the constraints on credit were an aspect of government fiscal policy.
Bank Reform in the UK: Part II – Return to the Dark Ages?

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‘To undo the integrated approach to risk assessment, would be to return regulation in the UK to the dark ages!’ (Sants)

1. The fall of the FSA

The banking crisis played an important part in the General Election of June 2010 with the Labour government claiming it was the consequence of exogenous events and that Gordon Brown had spearheaded the international response, and opposition parties arguing that the government’s reputation for economic management was shattered because of the failure both to prevent the crisis and to respond appropriately when it occurred. A victim of the backwash from these debates was the Financial Services Authority (FSA), which was implicated because the crisis occurred under its watch and, perhaps, because it had been a keystone in the fiscal structure introduced after Labour’s victory at the 1997 election. It was claimed that transferring bank regulation from the Bank of England to the FSA meant no agency had oversight of the financial system: the Financial Services and Markets Act 2000 had not made this one of the FSA’s functions, and, as a result, it concentrated on conduct of business. The tripartite system was meant to resolve such issues by providing a conduit between the FSA, the Bank and the Treasury; but the crisis revealed a failure of coordination between these bodies, characterised by Paul Tucker, from the Bank, as a problem of ‘underlap’. The strength of such claims was implicitly acknowledged in the Banking Act 2009, which gave the Bank statutory responsibility for financial stability and established the Financial Stability Committee at the Bank, although the relationship between this role and the FSA’s functions was left unclear.

George Osborne, when Shadow Chancellor of the Exchequer, concluded that a complete restructuring of the regulatory system was needed. He proposed that the FSA and the tripartite system be abolished. In their place ‘a strong and powerful Bank of England’ should be given responsibility – through a Financial Policy Committee – for macro-prudential and micro-prudential regulation. He argued this would ‘ensure that monetary policy, financial stability and the regulation of individual institutions are closely coordinated’. The Liberal-Democrat manifesto, on the other hand, did not suggest the abolition of the FSA or the tripartite system, but instead favoured a stronger relationship between the FSA and the Bank through a Council on Financial Stability. The Coalition agreement that followed the 2010 election contained a promise which, although short on detail, resembled the Conservative proposals. Nevertheless, when the FSA’s abolition was not immediately announced, rumours circulated that there had been a compromise between the parties which meant it would survive. As it turned out, George Osborne was working on his reforms and, crucially, he was planning how to reassure the City and the international markets that they would not cause uncertainty or weaken banking regulation. A key to this in his view was the conversion of Hector Sants, chief executive of the FSA, from opponent to supporter of reform so that he would stay on through the transition and then take a leading role when regulation returned to the Bank. In addition, Lord Turner, who had been appointed chair of the FSA at the height of the crisis in September 2008 and had conducted a well-received review of the FSA’s work, was persuaded to remain in post during the transition.

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2 Financial Services and Markets Act 2000, s. 2(2).
In the curious way that such things are often done in a modern parliamentary democracy, Osborne outlined his proposals in a speech to the City at Mansion House in June 2010. It was not until the following day that Mark Hoban, Financial Secretary to the Treasury, rose to make a statement to the House of Commons. Although dramatic in themselves, these statements were very brief and were only fleshed out in a Treasury paper published in July. This is an unusual document. It is a consultation, but the matters on which contributions are invited are shaped by the announcement concerning the key issue of the architecture of regulation, which is firmly fixed. The consultation process will involve two stages. The first is on the issues highlighted by the Treasury in its paper, which is discussed in this article. This will lead to the publication in early 2011 of a further consultation paper, which will include a draft of the proposed bill. It is expected that a bill will be introduced in mid-2011 with enactment by the following year.

In light of some of things said before the election, it comes as a surprise that the ministerial announcements and the Treasury’s paper are relatively mild in respect of the FSA. There is some criticism of past failures and, in particular, those highlighted by the collapse of Northern Rock in 2007; but this merely echoes what the FSA had itself acknowledged in the Turner Review. Instead, there is sympathy for the FSA’s impossible position and congratulations on the progress it has made in fixing the problems encountered. This is doubtless, in part, because the FSAs morale and authority needs to be maintained during the eighteen months or so before a new structure can take over and because its chief executive and many of its staff will play a role in that new structure. The true villain of the piece is identified as the tripartite system, which failed to paper over the cracks:

‘the financial crisis demonstrated the inadequacies of the tripartite system of financial stability regulation. The fragmented structure, with responsibilities, powers and capabilities split amongst institutions in an ill-defined way, was exposed as unable to address effectively the challenges the regulatory system faced.’

Nevertheless, the proposals sweep away, not only the tripartite system, but also the FSA.

2. Twin peaks

The proposals see the problem as being that no agency had responsibility for taking a systemic overview and that such an overview can only properly be conducted by the central bank. This analysis made the return of the core regulatory functions to the Bank of England inevitable and so beyond discussion. Yet, it does not mean the only solution is the structure put forward in the proposals, which involves a version of ‘twin peaks’ – an idea developed in the 1990s by, among others, Michael Taylor. He argued that there should be two regulators: one for prudential supervision, concerned with the stability of the system and individual firms, and the other would oversee conduct of business, that is, broadly, the relationship between firms and customers. Taylor argued that splitting the functions meant each would be more likely to receive equal attention. Although the Labour government rejected the idea in 1997, versions were adopted in Australia and the Netherlands, and during the crisis interest in it revived. Sir Andrew Large, who had served as chair of the Securities and Investments Board and deputy governor of the Bank of England, expressed concern that the lessons of the banking crisis might be rapidly forgotten, and that on its own the FSA might struggle to constrain banks from engaging in the sort of risk-taking which had created the problems, particularly if those banks were supported by politicians keen to see economic growth. He argued that the Bank was ideally placed to supervise the financial system by virtue of its independence from political interference, its access to information about the markets, its role as a source of liquidity and the various fiscal tools at its disposal. The FSA, he thought, could be left to deal with conduct-of-business supervision. This, however, left the problem of the relationship between the FSA and the Bank and raised the spectre of some version of the tripartite system. In a paper for the Centre for Policy Studies, Sir Martin Jacomb, who had been an external director of

**Notes**


10 A new approach to financial regulation: judgment, focus and stability, July 2010, cm 7874.

11 The Treasury select committee is also inquiring into the government’s proposals: <tinyurl.com/3sgao7>.


14 A new approach to financial regulation, n. 10 above, para. 6.1.


the Bank, argued that regulation should be returned to the Bank with systemic supervision handed to a committee and the FSA becoming a subsidiary of the Bank with responsibility for conduct of business.\(^\text{17}\)

In the end, the Treasury adopted a form of twin peaks similar to Jacomb’s proposal, comprising the Prudential Regulation Authority (PRA), which will be a subsidiary of the Bank and act as the prudential regulator, and the Consumer Protection and Markets Authority (CPMA).\(^\text{18}\) which, like the FSA, will be a company limited by guarantee and which will supervise conduct of business. In addition, the Financial Policy Committee (FPC) will be established within the Bank and will have oversight of the financial system.\(^\text{19}\) This structure will be informally put into place ahead of legislation through reorganisation of the FSA, which, with guidance from the Bank, will contain the forerunners of the PRA and the CPMA, and through the establishment of the FPC at the Bank. The Treasury hopes to achieve two main objectives by creating this new structure. The first is to restore the connection between, on the one hand, the central banking and financial stability functions of the Bank, and, on the other hand, the regulation of financial services and markets, while maintaining the primacy of systemic issues. The second is to address the tensions between systemic, prudential and conduct of business supervision.

3. The new regulators

The FPC will not strictly be part of the regulatory structure, instead it will have a strategic role to address macro-prudential issues, although in performing its functions it will be able to direct the two regulators: so, for instance, the PRA will be ‘the key implementer of macro-prudential policy’.\(^\text{20}\) The FPC’s objective is to protect financial stability: ‘improving the resilience of the financial system by identifying and addressing aggregate risks and vulnerabilities’ and ‘enhancing macroeconomic stability by addressing imbalances through the financial system, e.g. by damping the credit cycle’,\(^\text{21}\) while taking into account the effect of its decisions on, in particular, lending to business and families and the competitiveness of UK banks in relation to foreign banks. As part of this role it will monitor the impact of actions by other regulators. If the FPC identifies an issue that requires action, it will have a number of options: it can use one of the tools at its disposal; it can direct the PRA and the CPMA or make recommendations to the Bank, such as addressing a perceived lack of liquidity; and it can recommend changes in the regulatory system to the Treasury. The precise nature of the tools available to the FPC are under consideration, but might include: countercyclical capital requirements by which banks would be obliged to hold additional capital during an upswing in the economy to help them absorb losses in any downturn and to dampen lending; overall limits on the amount of leverage a bank could hold; forward-looking loss provision to oblige banks to hold greater reserves to cover future losses.

The FPC will comprise: six executives from the Bank, including the Governor and the Deputy Governors for monetary policy and financial stability and two executives responsible for these areas, which will facilitate interaction with the Monetary Policy Committee and the PRA; the chief executive of the CPMA, so that systemic issues arising from the work of that body can be identified by the FPC; and four other members from outside the Bank drawn from across the financial sector. There will also be a non-voting representative from the Treasury who will act as a conduit for government’s economic policy.

The Treasury lays great emphasis on the need for transparency and accountability in the new system. To this end, the FPC will publish minutes of its meetings and a six-monthly Financial Stability Report (FSR) summing up its assessment of the financial sector, the risks identified and the reasons for any action taken. As a committee of the Bank, it will be accountable to the Court of Directors. In addition, the Governor will meet the Chancellor following each FSR to discuss issues raised by the FPC and the PRA, and edited minutes of these meetings will be published. The Treasury will lay the FSR before Parliament and the FPC’s work will be covered by the Bank’s annual report, which is also laid before Parliament. The Treasury Select Committee will, doubtless, hold hearings on the FPC, as it already does on the Monetary Policy Committee.

The primary objective of the PRA is to use its regulatory powers ‘to promote the stable and prudent operation of the financial system through the effective regulation of financial firms, in a way which minimises the disruption caused by any firms which do fail’.\(^\text{22}\) Like the FSA, the PRA will be required to have regard to a range of factors and to act proportionately, but in the

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18 This is referred to as a working title, but in the way of such things it is likely to stick.
19 See *A new approach to financial regulation*, n. 10 above, chap. 2 (FPC), chap. 3 (PRA) and chap. 4 and 5 (CPMA). There will also be consultation on the creation of an Economic Crime Agency.
20 Ibid., para. 3.10.
21 Ibid., para. 2.24.
22 Ibid., para. 3.5.
event of conflict its primary objective will prevail. The PRA will be responsible for the authorisation and supervision of deposit-takers, broker-dealers (investment banks), insurers and associated activities. It will make rules and have the power to take enforcement action, although the Treasury proposes to tackle the slow and burdensome nature of rule making under the Financial Services and Markets Act 2000 (FSMA), and to simplify the rules built up by the FSA. But the FSA has also been attacked for being too light-touch in its regulation and encouraging mere box ticking:

‘In the run up to the financial crisis, financial supervision relied too much on ‘tick-box’ compliance with rules and directives at the expense of proper in-depth and strategic risk analysis. Effective prudential regulation of firms requires an approach based on understanding of their business models, and the ability to make judgements about the risks that firms’ activities pose to themselves and to the wider financial system as a whole.’

There need not be a conflict in that the rules may be complex and fail to achieve a safe system, but there is a danger in adopting a methodology which might be open to different interpretations.

The Treasury paper discusses the principles of good regulation that currently apply to the FSA, and, in particular, the government seems likely to remove the obligation to consider ‘the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom’ on the ground that it led the FSA to adopt its light-touch approach to regulation in order to encourage innovation without understanding the new financial products that were being permitted. This still leaves the question of whether the PRA should be obliged to consider the objective of improving competition between banks, which was given such emphasis by the Future of Banking Commission (FBC).

The PRA will be a subsidiary of the Bank. This is designed to give the Bank direct access to an important source of information required for its oversight of the financial system. It is also meant to enable the regulator to ‘benefit from the Bank’s judgement-driven culture’, and ‘from the expertise, experience and credibility of the central bank’. It will, however, be necessary to ensure that the connection with the Bank feeds down through both institutions and does not merely consist of shared executive board members. But that connection also needs to be balanced, so a majority of the PRA’s board’s membership will be non-executives appointed by the ‘Treasury to ensure effective oversight of its operation and ‘a constructive and independent challenge to rule-making’. Decision-making on supervision will be delegated to the executive members of the board, or, at least, to a committee in which they form the majority. The Bank will be accountable to the Court of the Bank for the PRA in respect of administrative issues and through the presence of Bank executives on the board. In addition, the PRA will publish an annual report, which the Treasury will lay before Parliament, and there will be some sort of accountability mechanism with respect to its legislative power, which will, presumably, be less burdensome than that applied to the FSA. The PRA will be subject to audit by the National Audit Office, which will allow further public and parliamentary scrutiny through the Public Accounts Committee, and the practice of FSA representatives giving evidence to the Treasury Select Committee will doubtless continue in respect of PRA officials.

The CPMA will be a company limited by guarantee and so formally independent of the government and the Bank. It will be governed by a board with a majority of non-executive members appointed by the Treasury and the Department of Business, Innovation and Skills, although an executive committee will take supervisory action. Accountability will be achieved by the publication of an annual report, which will be laid before Parliament by the Treasury; audit by the National Audit Office, which will bring the CPMA before the Public Accounts Committee; appearances of officials before the Treasury Select Committee; the holding of annual public meetings; consultative consumer and practitioner panels established under FSMA and the Small Business Practitioner Panel, which will be put onto a statutory footing; mechanisms allowing complaints and appeals to be brought against the CPMA; and provision for inquiries into its activities.

The establishment of the CPMA as a separate organisation from the PRA and the Bank is intended to ensure focus on consumer issues without the inclination to compromise macro- and micro-prudential supervision.

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**Notes**

23 Ibid., para. 1.7.
24 Financial Services and Markets Act 2000, s. 2.
25 Discussed in part I of this article. In July 2010, the Treasury Select Committee announced its own inquiry into competition in the banking industry: <tinyurl.com/37wsgtz>.
26 A new approach to financial regulation, n. 10 above, para. 3.29.
27 Ibid., para. 3.34.
28 Ibid.
29 BIS’s involvement arises from its responsibility for consumer and business matters.
30 Similar to that established under FSMA, sch. 1, para. 7.
31 FSMA, ss. 12, 14.
But, while this separation may hide conflicts, ultimately it cannot avoid the need to have a mechanism to negotiate them, and, in the end, systemic issues will take priority. It is intended that the CPMA will pick up what the post-Turner FSA started by providing ‘a tougher, more proactive and more focused approach to regulating conduct’.\textsuperscript{32} Its primary objective is to ensure ‘confidence in financial services and markets, with particular focus on protecting consumers and ensuring market integrity.’\textsuperscript{33} This will be balanced by the need to take into account certain issues when carrying out its functions, which fall into three categories: the objectives of other regulators, such as the impact of decisions by the CPMA on financial stability, which will require coordination with the CPMA and FPC; principles of good regulation, similar to those that apply to the FSA under section 2 of FSMA; and matters of public interest, such as the impact on lending, the promotion of public understanding of the financial system and the need to facilitate competition and access to suitable services.

All financial firms (whether or not they are regulated by the PRA) and dealings in wholesale markets will come under the CPMA. It will regulate conduct that affects, not just ordinary consumers and investors, but also those so-called sophisticated corporate investors, who broadly fell outside the FSA’s jurisdiction, since the credit crisis demonstrated how far reaching the consequences of their errors could be. The CPMA will have powers to make conduct-of-business rules and prudential rules that will apply to firms not regulated by the PRA; it will grant permission for non-PRA regulated activities; it will supervise firms and individuals and enforce compliance in respect of the activities it regulates; and it will carry out certain administrative functions, such as collecting levies on behalf of the regulatory system. The CPMA will also take responsibility for the Financial Ombudsman Service, the Consumer Financial Education Board and the Financial Services Compensation Scheme, although the role of the latter means its closest working connection is likely to be with the FCA. In addition, the government is planning to consult on the regulation of consumer finance, which is, at present, split between the FSA and the Office of Fair Trading, with the intention of transferring it to the CPMA.

The other part of the CPMA’s role will be to lead on conduct regulation in the wholesale financial markets and in representing the UK in the new European Securities and Markets Authority, which was established following the recommendations of the Larosière committee.\textsuperscript{34} However, the systemic importance of the settlement systems and central counterparty clearing houses means their regulation will be undertaken by the Bank, which will also continue to have responsibility for payment systems. The government is considering establishing a regulator of companies within the BIS (Department for Business, Innovation and Skills) to whom it would transfer the FSA’s role as the UK Listing Authority and the functions of the Financial Reporting Council. The aim would be to bring together all issues relating to companies, but this may mean losing sight of the distinctive nature of financial firms and markets and the importance of maintaining a clear sight of their activities. Moreover, the separation between the new regulator and the CPMA might recreate the problems of communication and coordination that arose under the tripartite system.

The Treasury paper recognises the importance of a robust framework in the management of any future systemic crisis. The Bank will be responsible for planning the response and carrying it into effect; but the implementation of any plan will need the cooperation of the Treasury because of the Chancellor’s control over expenditure and accountability to Parliament for the Bank and because of the political implications of crisis management. Of course, one purpose of the meeting between the Governor and the Chancellor after the publication of the Financial Stability Report by the FSC is to provide an opportunity to warn about, and to discuss, potential problems.

The expectation is that firms will take responsibility for their own crisis management. This was implicit in the FSAs frequent pre-crisis declarations that firms would be allowed to fail, but recent events have demonstrated that such statements do not come true by dint of mere repetition: there has to be planning. This will include an obligation on firms to draw up recovery and resolution plans under rules made by the PRA, which will either bring the firm back to health or effect an orderly winding down. The government contemplates increasing the actions currently available to the FSA under the own-initiative-variation-of-permission powers, including new points at which the power to intervene by the regulator can be triggered and obliging intervention once a threshold has been reached. There is a potential conflict arising from the special resolution regime (SSR), which was established by the Banking Act 2009, between the Bank’s role as the lead resolution authority and its responsibility through the PRA for the process of putting a firm into the SSR. The proposal for dealing with this involves contingency planning and resolutions being handled by the Deputy Governor for financial stability and the SSR falling within the

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32 A new approach to financial regulation, n. 10 above, para. 4.4.
33 Ibid., para. 4.6.
34 The High-Level Group on Financial Supervision in the EU (Larosière committee, Brussels, Feb. 2009) <tinyurl.com/c9bsze>.
jurisdiction of the chief executive of the PRA, that is, the Deputy Governor for prudential regulation.

4. Will the new system work?

Apportioning different regulators to deal with prudential regulation and conduct of business does mean that proper attention will be paid to both, but there is a danger that those matters dealt with outside the Bank by the CPMA will be regarded as subsidiary, while the PRA will be empowered by its connection to the Bank. Moreover, separation of issues into different agencies may affect efficiency in that it will mean more communications and monitoring. This will presumably increase the cost of regulation, which will be borne by the regulated firms and, therefore, by their customers. There may also be jurisdictional disputes, overlaps, miscommunication and competition between the agencies, which will not be cured simply by sharing board members, but which will require the creation of a culture of cooperation, coordination and consultation throughout the agencies and the Bank. Yet, cooperation will be hard to achieve because it is in the nature of organisations to compete and to fail to recognise issues that have significance for other organisations.

The proposals do not distinguish between the issue of whether it was wise to detach the Bank of England from regulation and the efficiencies offered by a unified system. While the reforms may not signal a return to the chaos of the mechanisms established by the Financial Services Act 1986, the Building Societies Act 1987, the Banking Acts 1979-87 and the Insurance Companies Act 1982, the creation of three agencies responsible for regulation suggests that, in spite of the opprobrium heaped upon the tripartite system, it must be replaced. The problem may not be particularly pressing during ‘normal’ times, but it is during a crisis that a lack of clarity may emerge and cause difficulties over the roles of, and the relationships between, the agencies, the Bank and the Treasury, even if the latter has the last say.15

Reconnecting monetary policy with regulation may make a good deal of sense; but it has been done with little thought about how effective the Bank might be as a regulator. Certainly, its recent history has been chequered. It only acquired statutory powers over bank regulation in 1979, but over the next two decades it was subject to censure by internal reviews, select committees and judicial inquiries over the handling of Johnson Matthey, BCCI and Barings: so, for instance, Sir Thomas Bingham said in relation to BCCI that the Bank ‘tended to lose sight of their primary duty to protect the bank’s UK depositors. I do not think that in this instance the Bank measured up to the task.’16 More recently, there has been criticism of its handling of Northern Rock and the Governor’s apparent about face over the issue of pumping funds into the banking system, following pressure from, among others, the FSA.17 Between 1997 and 2007 the Bank seemed to lose focus on the issue of financial stability, in part, because of its role in monetary policy and, in part, because, while recognising that asset prices and credit were spiralling upwards, the Bank took the view that the market would correct these problems. Eventually, the Banking Act 2009 made financial stability a statutory objective of the Bank. Nevertheless, while the FSA, the government and the banks were being castigated, the Bank emerged from the crisis, not merely unscathed, but with its reputation intact and its power enhanced.

Finally, placing hopes in a new structure invites disappointment since there is no solid evidence that any particular regulatory structure succeeded in either preventing or dealing with the crisis better than any other. Of those countries that operated a version of twin peaks, Canada and Australia emerged reasonably well from the crisis, but the Netherlands did not. Moreover, while bank regulation in the first two countries was in the hands of an independent agency, in the Netherlands it was undertaken within the central bank.18

5. The Independent Commission on Banking

Alongside the proposals for regulatory reform, the Chancellor announced the establishment of the Independent Commission on Banking chaired by Sir John Vickers. The commission began its meetings in July 2010, producing an issues paper in September 2010,19 which will be followed in Spring 2011 by a detailed analysis of the main reform options. The final report will be presented to the Cabinet Committee on Banking in September 2011.20 Although independent, the government’s influence is felt through setting the terms

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40 The Cabinet Committee is chaired by the Chancellor with Dr Vince Cable as Deputy Chair: ‘Sir John Vickers to chair the Independent Commission on Banking’ (2010) <hm-treasury.gov.uk/press_11_10.htm>.

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of the inquiry, the selection of the commission and, ultimately, the decision on whether to implement its recommendations. Aside from Sir John Vickers, an academic and one-time Chief Economist at the Bank, its members are Clare Spottiswoode, who was a member of the FBC, Martin Taylor, who has had various senior roles in business, including chief executive of Barclays, Bill Winters, who was at JPMorgan, and Martin Wolf, a leading financial journalist.

The commission’s inquiry will cover many of the concerns raised by the FBC, reducing systemic risk by looking at the risk posed by banks of different size, scale and function; mitigating moral hazard; reducing the likelihood and impact of bank failure; promoting competition to ensure customers’ needs are efficiently served; and addressing the competitive advantage of those banks perceived to be too big to fail. In its deliberations, the IBC is required to have regard to ‘the Government’s wider goals of financial stability and creating an efficient, open, robust and diverse banking sector’, and, in particular, the impact of its recommendations on financial stability, lending, the pace of economic recovery, consumer choice, competitiveness of the UK economy, and risks to the fiscal position of the government.

The commission identifies certain topics and within each it highlights a number of questions for discussion. The first topic involves the promotion of stability and competition: what is the relationship between these issues, are they in harmony and, if not, how can tensions between them be alleviated, and what weight should be given to other objectives (lending, the pace of economic recovery, competitiveness and risks to the government’s revenues)? The commission suggests that a key risk to stability is that the failure of one firm will cause the financial system to fail because of the interconnections between firms. The crisis has made the FSA ‘s view that no bank is too big to fail – the no zero-fail regime – unsustainable, but the IBC acknowledges that it may not be possible or even desirable to avoid having such banks. Like the FBC, the IBC points out the advantages these banks enjoy over those that are not systemically important and how their presence makes it more difficult for new entrants to the market, which inhibits competition. Moreover, the losses arising from such banks are met by the state, but any profits go to employees in the form of high pay and bonuses and to shareholders in dividends. This creates moral hazard – the incentive to take high risks because the risk-taker does not bear the consequences of their behaviour. The commission also notes that a handful of firms dominate the banking markets for personal accounts, mortgage lending and lending to SMEs and that competition is also limited among investment banks. Yet, the commission reflects a more sophisticated view than the FBC by pointing out that competition may undermine stability by reducing profitability and so encourage higher risk-taking, or it may diminish the incentive to sink resources into monitoring credit risk because of the likelihood that borrowers will move to other banks.

The second topic focuses on possible structural and non-structural reforms to banks and markets to tackle the problems identified. A simple example of the distinction would be that the objective of reducing the level of risk undertaken by banks might be achieved by government imposing capital and liquidity requirements (non-structural) or by prohibiting certain types of activities, such as proprietary trading or the mixing of retail and investment banking (structural). The IBC recognises the need to guard against the possibility of regulation or prohibition leading to activities shifting into unregulated forms, such as happened with the growth of shadow banking: but it is considering the separation of retail from investment banking, or the creation of a bank structure that would allow such activities to be easily unwound in the event of difficulties without affecting depositors, or the use of living wills and resolution schemes, which would involve planning for a crisis. Other possibilities under consideration include contingent capital, which would, for instance, mean that certain types of debt would convert into equity, and structure-related surcharges, which would increase capital and liquidity requirements for systemically important financial institutions. In relation to markets, like the FBC, the commission has put forward ideas about the reduction of market concentration, for instance, by requiring the regulator to promote competition, by obliging large banks to divest parts of their businesses, and by reform of market infrastructure, such as requiring securities to be traded though a central counterparty rather than over-the-counter, which should reduce exposures by facilitating the netting-off of trades.

Notes

41 Independent Commission on Banking, Terms of reference (2010) <tinyurl.com/2uvlclc>.
42 Ibid., para. 3.1.
43 H. Davies (chair of the FSA), ‘Rational expectations - what should the market and policyholders expect from insurance regulation?’ (Airmic annual lecture, 29 Jan. 2010).
44 This issue, which is discussed in Part I, was expressly raised by the Treasury for consideration by the commission.
45 See Part I.
46 The third topic concerns a cost-benefit assessment of the reforms, including the danger of problems migrating from the banking to the shadow-banking sector.
Bank Reform in the UK: Part II – Return to the Dark Ages?

6. The policies of reform

Reform is often as much about furthering a political agenda as it is about deep change. The reaction to the crisis has three main facets: the financial rescue package; the restructuring of the banking sector; and the reordering of rules and regulatory structures. The crisis offered an opportunity to alter the nature of banks by restricting the contractual freedom of banks to pay their employees, to break up large banks, to separate retail from investment banking and to facilitate competition for the benefit of customers. These issues were linked by the FBC, which saw the crisis as justifying change on all fronts; but in so far as governments are seeking to tackle them they are doing so separately. In the USA, the bank lobby mobilised its financial and political muscle to resist the break-up of banks, although the Volcker rule limiting proprietary trading has been implemented. In the UK, while the banks have been able to exercise less direct political influence, they have begun to push back, recognising that government has, perhaps, conceded the continued importance of a strong industry and even the force of the threat that banks may simply pick up their bats and balls and move to Switzerland or South-East Asia.48

Since the government’s post-election strategy has been to cool criticism of the FSA and instead to indenify the tripartite system as the true villain, its abolition of the FSA can only be explained in terms of politics and the attempt to fix the crisis to the last Labour government by attacking both its economic policy and its reform of the regulatory structure. After all, there is no evidence that another regulatory structure would have performed better, either in preventing the crisis or responding to it, and, in any case, the twin peaks idea and the involvement of the Bank in regulation could have been achieved by moving the FSA into the Bank. Announcing the FSA’s abolition removes any doubt that would have existed had the issue been part of the Treasury consultation process; but it creates doubt about the strength of the FSA and its ability to impose itself during the next couple of years. which is worrying when the economy in general and the banking sector in particular remain so fragile.49

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47 Even this was modified to allow 3% of Tier 1 capital to invested in private equity and hedge funds.
49 This is certainly the view of the Treasury’s Asset Protection Agency, Annual report and accounts 2009-10 of the Asset Protection Agency, HC 259 (July 2010), p. 4.
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