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The reform of UK financial regulation

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THE REFORM OF UK FINANCIAL REGULATION

by

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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,[i] 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.[ii] 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.[iii]

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.[iv] 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 review[v] 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.[vi] 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 deficiencies[vii] in the Basel I/II processes revealed during the financial crisis. Accordingly, he calls for the following:

(i) an increase in both the quality[viii] 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;[ix]

(iv) the introduction of a counter-cyclical capital adequacy regime, with capital buffers increasing in economic upswings and decreasing in recessions;[x] and

(v) the introduction of a backstop maximum gross leverage ratio[xi] 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.[xii] 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.[xiii]

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 arbitraged 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,[xiv] 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.[xv] He also recommends that consideration be given to the introduction of a 'core funding ratio' to ensure sustainable funding of balance sheet growth.

Remuneration[xvi]

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 superceded 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).[xvii] 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,[xviii] 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 effectives."

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.[xix] 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' tax[xx] 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 pubic 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.[xxi] 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 Approach[xxii]

In recognition of the failings of the past[xxiii] 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.[xxiv] 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 be 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 area[xxv] 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.[xxvi]

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.[xxvii] 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 two[xxviii] 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,[xxix] 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'.[xxx]

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).[xxxi] 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.[xxxii] 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.[xxxiii]

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,[xxxiv] 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).[xxxv]

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).[xxxvi] 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.[xxxvii]

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 vehicles[xxxviii] and hedge funds,[xxxix] 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.[xl] These additional tools can be used to complement the action already taken by the FSA[xli] 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.[xlii]

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,[xliii] this will be decided once international agreement has been reached on what the new tools should be, and how they are to be used.[xliv] [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 done[xlv] in these areas, the Government believes there is still scope for a further strengthening of regulation and international co-operation, particularly in Europe.[xlvi] 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 2009[xlvii] 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,[xlviii] 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).[xlix]

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")[l] 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,[li] 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:[lii]

- 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;[liii]
- 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.[liv] 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.[lv] 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 intrusive[lvi] 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.[lvii]

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);[lviii]
- 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.[lix]

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?[lx] With respect to the former debate (*see*, for example, Goodhart and Schoenmaker, 1995, and Peek, Rosenburg 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.[lxi] 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.[lxii] 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.[lxiii]

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.[lxiv] 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,[lxv] 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,[lxvi] 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.[lxvii] 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 distanced[lxviii] 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'!

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APPENDIX 1 : A BRIEF SUMMARY OF THE BANKING ACT 2009*

♦ The centrepiece is a permanent '*special resolution regime*' (SRR) which provides the Authorities with a range of tools to deal with banks in financial difficulties. It builds on and refines the temporary tools introduced by the Banking (Special Provisions) Act 2008, which was used to bring Northern Rock plc into temporary public ownership in February 2008, and to resolve Bradford and Bingley plc in September 2008 and the UK subsidiaries of two Icelandic banks in 2008.

♦ *Other measures* contained in the Act relate to: improvement to the legal framework surrounding the operation of the Financial Services Compensation Scheme; enhancement of the operation of the regulatory frameworks preventing firms from failing; consumer protection; strengthening of the Bank of England; and new powers for the Treasury to lay regulations to deal with Investment Bank insolvency.

♦ With respect to the **SRR**, provisions relate to stabilisation options (of which there are three), bank insolvency procedures and bank administration procedures. Each of the three stabilisation options is achieved through the exercise of one or more of the 'stabilisation powers' – the transfer of shares or the transfer of property.

- The *objectives* of the SRR are as follows:
  - to protect and enhance the stability of the financial systems of the UK (including the continuity of banking services);
  - to protect and enhance public confidence in the stability of the banking systems of the UK;
  - to protect depositors;
  - to protect public funds; and
  - to avoid interfering with property rights in contravention of a Convention right (within the meaning of the Human Rights Act 1980).

  The Authorities must have regard to these objectives when using, or considering using, their SRR powers, which are also covered by a Treasury 'Code of Practice'. A 'Banking Liaison Panel' will also advise the Treasury on the likely impact of the SRR on banks, their customers and financial markets.

- *Exercise of the Stabilisation Powers*
  - · A stabilisation power may only be exercised if the **FSA** is satisfied that the following conditions are met:
    - that the bank is failing, or is likely to fail, to satisfy the 'threshold conditions' (within the meaning of section 41(1) of the Financial Services and Markets Act 2000, which relates to permission to carry on regulated activities); and
    - that, having regard to timing and other relevant circumstances, it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions.

Before deciding whether the second condition is met, the FSA must consult with both the Bank of England and the Treasury.

· The **Bank of England** may exercise a stabilisation power *in respect of a bank transfer to a private sector purchaser or a bridge bank* only if it is satisfied that it is necessary to secure the public interest (i.e. in relation to financial system stability, public confidence in the stability of the banking system and depositor protection).

  Before determining whether this condition is met, and if so how to react, the Bank must consult with the FSA and the Treasury.

  Alternatively, where the Treasury notify the Bank that they have provided financial assistance in respect of a bank for the purpose of resolving or reducing a serious threat to the stability of the UK financial systems, the Bank may again exercise a stabilisation power only if it is satisfied that the Treasury have recommended such action in order to protect the public interest and that, in the Bank's opinion, this is an appropriate way to provide that protection.

· *In respect of a bank transfer to temporary public ownership*, the **Treasury** may only exercise a stabilisation power if it is satisfied that one of the following conditions is met:
  - that the exercise of the power is necessary to resolve or reduce a serious threat to UK financial system stability; or
  - that the exercise of the power is necessary to protect the public interest, where the Treasury have provided financial assistance in respect of the bank for the purpose of resolving or reducing a serious threat to UK financial system stability.

  Before determining whether either condition is met, the Treasury must consult with the FSA and the Bank of England.

  [N.B. The above arrangements confirm that it is the FSA, sometimes following consultation with both the Bank and the Treasury, that actually 'triggers' the use of a stabilisation power under the SRR, although it is the Bank/Treasury which then assumes operational responsibility for the exercise of such powers, following consultation with the other Authorities.]

- *The Stabilisation Options*
  · The three stabilisation options comprise:
    - selling all or part of the bank's business to a commercial purchaser;
    - transferring all or part of the bank's business to a company which is wholly-owned by the Bank (a "bridge bank"); and
    - taking the bank into temporary public ownership.

♦ **Bank Insolvency Arrangements**

The main features of the bank insolvency arrangements are as follows:
- a bank enters the process by court order;
- the order appoints a bank liquidator;
- the bank liquidator aims to arrange for the bank's eligible depositors to have their accounts transferred or to receive their eligible compensation from the FSCS; and
- the bank liquidator then winds up the bank.

- *The Bank Insolvency Order*
  - Application for such an order may be made to the court by the Bank of England, the FSA or the Secretary of State on the following grounds:
    (A) that the bank is unable, or likely to become unable, to pay its debts;
    (B) that the winding up of the bank would be in the public interest; and
    (C) that the winding up of the bank would be fair.
  - The **Bank of England** may apply for a bank insolvency order only if:
    - the FSA has informed the Bank that it is satisfied that the general conditions for the exercise of a stabilisation power are met; and
    - the Bank is satisfied that the bank has eligible depositors and that Ground (A) or (C) applies.
  - The **FSA** may apply for a bank insolvency order only if:
    - the Bank consents; and
    - the FSA is satisfied that the general conditions for the exercise of a stabilisation order are met, that the bank has eligible depositors and that Ground (A) or (C) applies.
  - Finally, the **Secretary of State** may apply for a bank insolvency order only if satisfied that the bank has eligible depositors and that Ground (B) applies.

- *The Bank Insolvency Process*
  - A bank liquidator has two *objectives*:
    - to work with the FSCS so as to ensure that, as soon as is reasonably practicable, each eligible depositor has the relevant account transferred to another financial institution, or receives payment from (or on behalf of) the FSCS; and
    - to wind up the affairs of the bank, so as to achieve the best result for the bank's creditors as a whole.

    The first objective takes precedence over the second, although the bank liquidator is obliged to begin working towards both objectives immediately upon appointment.
  - Following a bank insolvency order, a *liquidation committee* must be established, for the purpose of ensuring that the bank liquidator properly exercises the functions prescribed in the Act.

    This committee shall consist of three individuals, one nominated by each of the Bank, the FSA and the FSCS.

♦ Bank Administration Arrangements

- The main features of the bank administration arrangements are that:
  - it is used where part of the business of a bank is sold to a commercial purchaser or to a bridge bank in accordance with the relevant provision of the Act;
  - the court appoints a bank administrator on the application of the Bank;
  - the bank administrator is able and required to ensure that the non-sold or non-transferred part of the bank (the 'residual bank') provides services or facilities required to enable the commercial purchaser or the transferee (the 'bridge bank') to operate effectively; and

- in other respects, the process is the same as for normal administration under the Insolvency Act 1986, subject to specified modifications.

- A bank administrator has two *objectives*:
  - to provide support to the commercial purchaser or bridge bank; and
  - to engage in "normal" administration (i.e. to rescue the bank as a going concern or achieve a better result for the residual bank's creditors as a whole than would be likely if the residual bank were wound up without first being in bank administration).

  The first objective takes priority over the second objective although, upon appointment, a bank administrator is obliged to begin working towards securing both objectives immediately.

- An *application* for a bank administration order may be made to the court by the Bank of England, wherein a person to be appointed as the bank administrator must be nominated and the bank be given due notice of the application.
  The grounds for said application are:
  - that the Bank has made or intends to make a property transfer instrument in respect of the bank in accordance with the relevant sections of the Act relating to such transfers to a commercial purchaser or a bridge bank; and
  - that the Bank is satisfied that the residual bank is either unable to pay its debts or is likely to become unable to pay its debts as a result of the property transfer instrument which the Bank intends to make.

*Which received the Royal Assent on 12.2.09 and took effect on 21.2.09.

APPENDIX 2 : A BRIEF SUMMARY OF THE TURNER REVIEW*

- ♦ Following a review of the causes of the current global banking crisis, Lord Turner identifies the changes in regulation and supervisory approach needed to create a more stable and effective banking system which the FSA has already implemented or plans to introduce and/or which it is proposing in international fora.

- ♦ The former set of recommended initiatives comprise the following:

Capital adequacy, accounting and liquidity

1. The quality and quantity of overall capital in the global banking system should be increased, resulting in minimum regulatory requirements significantly above existing Basel rules. The transition to future rules should be carefully phased given the importance of maintaining bank lending in the current macroeconomic climate.
2. Capital required against trading book activities should be increased significantly (e.g. several times) and a fundamental review of the market risk capital regime (e.g. reliance on VAR measures for regulatory purposes) should be launched.
3. Regulators should take immediate action to ensure that the implementation of the current Basel II capital regime does not create unnecessary procyclicality; this can be achieved by using 'through the cycle' rather than 'point in time' measures of probabilities of default.
4. A counter-cyclical capital adequacy regime should be introduced, with capital buffers which increase in economic upswings and decrease in recessions.
5. Published accounts should also include buffers which anticipate potential future losses, through, for instance, the creation of an 'Economic Cycle Reserve'.
6. A maximum gross leverage ratio should be introduced as a backstop discipline against excessive growth in absolute balance sheet size.
7. Liquidity regulation and supervision should be recognised as of equal importance to capital regulation.
   - More intense and dedicated supervision of individual banks' liquidity positions should be introduced, including the use of stress tests defined by regulators and covering system-wide risks.
   - Introduction of a 'core funding ratio' to ensure sustainable funding of balance sheet growth should be considered.

Institutional and geographic coverage of regulation

8. Regulatory and supervisory coverage should follow the principle of economic substance not legal form.
9. Authorities should have the power to gather information on all significant unregulated financial institutions (e.g. hedge funds) to allow assessment of overall system-wide risks. Regulators should have the power to extend prudential regulation of capital and liquidity or impose other restrictions if any institution or group of institutions develops bank-like features that threaten financial stability and/or otherwise become systemically significant.

10. Offshore financial centres should be covered by global agreements on regulatory standards.

Deposit insurance

11. Retail deposit insurance should be sufficiently generous to ensure that the vast majority of retail depositors are protected against the impact of bank failure (note: already implemented in the UK).
12. Clear communication should be put in place to ensure that retail depositors understand the extent of deposit insurance cover.

UK bank resolution

13. A resolution regime which facilities the orderly wind down of failed banks should be in place (already done via the Banking Act 2009 – *see* Appendix 1).

Credit rating agencies

14. Credit rating agencies should be subject to registration and supervision to ensure good governance and management of conflicts of interest and to ensure that credit ratings are only applied to securities for which a consistent rating is possible.
15. Rating agencies and regulators should ensure that communication to investors about the appropriate use of ratings makes clear that they are designed to carry inference for credit risk, not liquidity or market price.
16. There should be a fundamental review of the use of structured finance ratings in the Basel II framework.

Remuneration

17. Remuneration policies should be designed to avoid incentives for undue risk taking; risk management considerations should be closely integrated into remuneration decisions. This should be achieved through the development and enforcement of UK and global codes.

Credit Default Swap (CDS) market infrastructure

18. Clearing and central counterparty systems should be developed to cover the standardised contracts which account for the majority of CDS trading.

Macro-prudential analysis

19. Both the Bank of England and the FSA should be extensively and collaboratively involved in macro-prudential analysis and the identification of policy measures. Measures such as counter-cyclical capital and liquidity requirements should be used to offset these risks.
20. Institutions such as the IMF must have the resources and robust independence to do high quality macro-prudential analysis and if necessary to challenge conventional intellectual wisdoms and national policies.

FSA supervisory approach

21. The FSA should complete the implementation of its Supervisory Enhancement Program (SEP) which entails a major shift in its supervisory approach with:
    - Increase in resources devoted to high impact firms and in particular to large complex banks.
    - Focus on business models, strategies, risks and outcomes, rather than primarily on systems and processes.
    - Focus on technical skills as well as probity of approved persons.
    - Increased analysis of sectors and comparative analysis of firm performance.
    - Investment in specialist prudential skills.
    - More intensive information requirements on key risks (e.g. liquidity).
    - A focus on remuneration policies.
22. The SEP changes should be further reinforced by:
    - Development of capabilities in macro-prudential analysis.
    - A major intensification of the role the FSA plays in bank balance sheet analysis and in the oversight of accounting judgements.

Firm risk management and governance

23. The Walker Review should consider in particular:
    - Whether changes in governance structure are required to increase the independence of risk management functions.
    - The skill level and time commitment required for non-executive directors of large complex banks to perform effective oversight of risks and provide challenge to executive strategies.

Utility banking versus investment banking

24. New capital and liquidity requirements should be designed to constrain commercial banks' role in risky proprietary trading activities. A more formal and complete legal distinction of 'narrow banking' from market making activities is not feasible.

Global cross-border banks

25. International co-ordination of bank supervision should be enhanced by:
    - The establishment and effective operation of colleges of supervisors for the largest complex and cross-border financial institutions.
    - The pre-emptive development of crisis co-ordination mechanisms and contingency plans between supervisors, central banks and finance ministries.
26. The FSA should be prepared more actively to use its powers to require strongly capitalised local subsidiaries, local liquidity and limits to firm activity, if needed to complement improved international co-ordination.

European cross-border banks

27. A new European institution should be created which will be an independent authority with regulatory powers, a standard setter and overseer in the area of supervision, and will be significantly involved in macro-prudential analysis. This body should replace

the Lamfalussy Committees. Supervision of individual firms should continue to be performed at national level.

28. The untenable present arrangements in relation to cross-border branch pass-porting rights should be changed through some combination of:
    - Increased national powers to require subsidiarisation or to limit retail deposit-taking.
    - Reforms to European deposit insurance rules which ensure the existence of pre-funded resources to support deposits in the event of a bank failure.

♦ Another set of *possible* policy initiatives deserving of further debate are then identified. These relate to the following open questions:

29. Should the UK introduce product regulation of mortgage market Loan-to-Value (LTV) or Loan-to-Income (LTI)?
30. Should financial regulators be willing to impose restrictions on the design or use of wholesale market products (e.g. CDS)?
31. Does effective macro-prudential policy require the use of tools other than the variation of counter-cyclical capital and liquidity requirements e.g.
    - Through the cycle variation of LTV or LTI ratios?
    - Regulation of collateral margins ('haircuts') in derivatives contracts and secured financing transactions?
32. Should decisions on for instance short selling recognise the dangers of market irrationality as well as market abuse?

♦ The final chapter (Chapter 4) summaries the recommendations, distinguishes those which can be implemented by the FSA acting alone and those where international agreement is needed, and discusses the appropriate pace and process of implementation.

Source: FSA, 2009a

*Additional information on FSA thinking is provided in FSA, 2009b.

APPENDIX 3 : RECOMMENDATIONS OF THE WALKER REVIEW OF CORPORATE GOVERNANCE OF UK FINANCIAL INSTITUTIONS

Board size, composition and qualification

Recommendation 1
To ensure that NEDs have the knowledge and understanding of the business to enable them to contribute effectively, a BOFI board should provide thematic business awareness sessions on a regular basis and each NED should be provided with a substantive personalised approach to induction, training and development to be reviewed annually with the chairman.

Recommendation 2
A BOFI board should provide for dedicated support for NEDs on any matter relevant to the business on which they require advice separate from or additional to that available in the normal board process.

Recommendation 3
NEDs on BOFI boards should be expected to give greater time commitment than has been normal in the past. A minimum expected time commitment of 30 to 36 days in a major bank board should be clearly indicated in letters of appointment and will in some cases limit the capacity of the NED to retain or assume board responsibilities elsewhere.

Recommendation 4
The FSA's ongoing supervisory process should give closer attention to both the overall balance of the board in relation to the risk strategy of the business and take into account not only the relevant experience and other qualities of individual directors but also their access to an induction and development programme to provide an appropriate level of knowledge and understanding as required to equip them to engage proactively in board deliberation, above all on risk strategy.

Recommendation 5
The FSA's interview process for NEDs proposed for major BOFI boards should involve questioning and assessment by one or more senior advisers with relevant industry experience at or close to board level of a similarly large and complex entity who might be engaged by the FSA for the purpose, possibly on a part-time panel basis.

Functioning of the board and evaluation of performance

Recommendation 6
As part of their role as members of the unitary board of a BOFI, NEDs should be ready, able and encouraged to challenge and test proposals on strategy put forward by the executive. They should satisfy themselves that board discussion and decision-taking on risk matters is based on accurate and appropriately comprehensive information and draws, as far as they believe it to be relevant or necessary, on external analysis and input.

Recommendation 7
The chairman should be expected to commit a substantial proportion of his or her time, probably not less than two-thirds, to the business of the entity, with clear understanding from the outset that, in the event of need, the BOFI chairmanship role would have priority over any other business time commitment.

Recommendation 8
The chairman of the BOFI board should bring a combination of relevant financial industry experience and a track record of successful leadership capability in a significant board position. Where this desirable combination is only incompletely achievable, the board should give particular weight to convincing leadership experience since financial industry experience without established leadership skills is unlikely to suffice.

Recommendation 9
The chairman is responsible for leadership of the board, ensuring its effectiveness in all aspects of its role and setting its agenda so that fully adequate time is available for substantive discussion on strategic issues. The chairman should facilitate, encourage and expect the informed and critical contribution of the directors in particular in discussion and decision-taking on matters of risk and strategy and should promote effective communication between executive and non-executive directors. The chairman is responsible for ensuring that the directors receive all information that is relevant to the discharge of their obligations in accurate, timely and clear form.

Recommendation 10
The chairman of a BOFI board should be proposed for election on an annual basis.

Recommendation 11
The role of the senior independent director (SID) should be to provide a sounding board for the chairman, for the evaluation of the chairman and to serve as a trusted intermediary for the NEDs as and when necessary. The SID should be accessible to shareholders in the event that communication with the chairman becomes difficult or inappropriate.

Recommendation 12
The board should undertake a formal and rigorous evaluation of its performance with external facilitation of the process every second or third year. The statement on this evaluation should be a separate section of the annual report describing the work of the board, the nomination or corporate governance committee as appropriate. Where an external facilitator is used, this should be indicated in the statement, together with an indication whether there is any other business relationship with the company.

Recommendation 13
The evaluation statement should include such meaningful, high-level information as the board considers necessary to assist shareholders' understanding of the main features of the evaluation process. The board should disclose that there is an ongoing process for identifying the skills and experience required to address and challenge adequately the key risks and decisions that confront the board, and for evaluating the contributions and commitment of individual directors. The statement should also provide an indication of the nature and extent of communication by the chairman and major shareholders.

The role of institutional shareholders: communication and engagement

Recommendation 14
Boards should ensure that they are made aware of any material changes in the share register, understand as far as possible the reasons for changes to the register and satisfy themselves that they have taken steps, if any are required, to respond.

Recommendation 15
In the event of substantial change over a short period in a BOFI share register, the FSA should be ready to contact major selling shareholders to understand their motivation and to seek from the BOFI board an indication of whether and how it proposes to respond.

Recommendation 16
The remit of the FRC should be explicitly extended to cover the development and encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. This new role should be clarified by separating the content of the present Combined Code, which might be described as the Corporate Governance Code, from what might appropriately be described as Principles for Stewardship.

Recommendation 17
The present best practice "Statement of Principles – the Responsibilities of Institutional Shareholders and Agents" should be ratified by the FRC and become the core of the Principles for Stewardship. By virtue of the independence and authority of the FRC, this transition to sponsorship by the FRC should give materially greater weight to the Principles.

Recommendation 18
The ISC, in close consultation with the FRC as sponsor of the Principles, should review on an annual basis their continuing aptness in the light of experience and make proposals for any appropriate adaptation.

Recommendation 19
Fund managers and other institutions authorised by the FSA to undertake investment business should signify on their websites their commitment to the Principles of Stewardship. Such reporting should confirm that their mandates from life assurance, pension fund and other major clients normally include provisions in support of engagement activity and should describe their policies on engagement and how they seek to discharge the responsibilities that commitment to the Principles entails. Where a fund manager or institutional investor is not ready to commit and to report in this sense, it should provide, similarly on the website, a clear explanation of the reasons for the position it is taking.

Recommendation 20
The FSA should encourage commitment to the Principles of Stewardship as a matter of best practice on the part of all institutions that are authorised to manage assets for others and, as part of the authorisation process, and in the context of feasibility of effective monitoring to require clear disclosure of such commitment on a "comply or explain" basis.

Recommendation 21
To facilitate effective collective engagement, a Memorandum of Understanding should be prepared, initially among major long-only investors, to establish a flexible and informal but agreed approach to issues such as arrangements for leadership of a specific initiative, confidentiality and any conflicts of interest that might arise. Initiative should be taken by the FRC and major UK fund managers and institutional investors to invite potentially interested major foreign institutional investors, such as sovereign wealth funds and public sector pension funds, to commit to the Principles of Stewardship and, as appropriate, to the Memorandum of Understanding on collective engagement.

Recommendation 22
Voting powers should be exercised, fund managers and other institutional investors should disclose their voting record, and their policies in respect of voting should be described in statements on their websites or in other publicly accessible form.

Governance of risk

Recommendation 23
The board of a BOFI should establish a board risk committee separately from the audit committee with responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy. In preparing advice to the board on its overall risk appetite and tolerance, the board risk committee should take account of the current and prospective macro-economic and financial environment drawing on financial stability assessments such as those published by the Bank of England and other authoritative sources that may be relevant for the risk policies of the firm.

Recommendation 24
In support of board-level risk governance, a BOFI board should be served by a CRO who should participate in the risk management and oversight process at the highest level on an enterprise-wide basis and have a status of total independence from individual business units. Alongside an internal reporting line to the CEO or FD, the CRO should report to the board risk committee, with direct access to the chairman of the committee in the event of need. The tenure and independence of the CRO should be underpinned by a provision that removal from office would require the prior agreement of the board. The remuneration of the CRO should be subject to approval by the chairman or chairman of the board remuneration committee.

Recommendation 25
The board risk committee should have access to and, in the normal course, expect to draw on external input to its work as a means of taking full account of relevant experience elsewhere and in challenging its analysis and assessment.

Recommendation 26
In respect of a proposed strategic transaction involving acquisition or disposal, it should as a matter of good practice be for the board risk committee to oversee a due diligence appraisal of the proposition, drawing on external advice where appropriate and available, before the board takes a decision whether to proceed.

Recommendation 27
The board risk committee (or board) risk report should be included as a separate report within the annual report and accounts. The report should describe the strategy of the entity in a risk management context, including information on the key exposures inherent in the strategy and the associated risk tolerance of the entity and should provide at least high level information on the scope and outcome of the stress-testing programme. An indication should be given of the membership of the committee, of the frequency of its meetings, whether external advice was taken and, if so, its source.

Remuneration

Recommendation 28
The remit of the remuneration committee should be extended where necessary to cover all aspects of remuneration policy on a firm-wide basis with particular emphasis on the risk dimension.

Recommendation 29
The terms of reference of the remuneration committee should be extended to oversight of remuneration policy and remuneration packages in respect of all executives for whom total remuneration in the previous year or, given the incentive structure proposed, for the current year exceeds or might be expected to exceed the median compensation of executive board members on the same basis.

Recommendation 30
In relation to executives whose total remuneration is expected to exceed that of the median of executive board members, the remuneration committee report should confirm that the committee is satisfied with the way in which performance objectives are linked to the related compensation structures for this group and explain the principles underlying the performance objectives and the related compensation structure if not in line with those for executive board members.

Recommendation 31
The remuneration committee report should disclose for "high end" executives whose total remuneration exceeds the executive board median total remuneration, in bands, indicating numbers of executives in each band and, within each band, the main elements of salary, bonus, long-term award and pension contribution.

Recommendation 32
Major FSA-authorised BOFIs that are UK-domiciled subsidiaries of non-resident entities should include in their reporting arrangements with the FSA disclosure of the remuneration of "high end" executives broadly as recommended for UK-listed entities but with detail appropriate to their governance structure and circumstances agreed on a case by case basis with the FSA. Disclosure of "high end" remuneration on the agreed basis should be included in the annual report of the entity that is required to be filed at Companies House.

Recommendation 33
Deferral of incentive payments should provide the primary risk adjustment mechanism to align rewards with sustainable performance for executive board members and executives whose remuneration exceeds the median for executive board members. Incentives should be balanced so that at least one-half of variable remuneration offered in respect of a financial year is in the form of a long-term incentive scheme with vesting subject to a performance condition with half of the award vesting after not less than three years and of the remainder after five years. Short-term bonus awards should be paid over a three year period with not more than one-third in the first year. Clawback should be used as the means to reclaim amounts in limited circumstances of misstatement and misconduct.

Recommendation 34
Executive board members and executives whose total remuneration exceeds that of the median of executive board members should be expected to maintain a shareholding or retain a portion of vested awards in an amount at least equal to their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee. Vesting of stock for this group should not normally be accelerated on cessation of employment other than on compassionate grounds.

Recommendation 35
The remuneration committee should seek advice from the board risk committee on an arm's-length basis on specific risk adjustments to be applied to performance objectives set in the context of incentive packages; in the event of any difference of view, appropriate risk adjustments should be decided by the chairman and NEDs on the board.

Recommendation 36
If the non-binding resolution of a remuneration committee report attracts less than 75 per cent of the total votes cast, the chairman of the committee should stand for re-election in the following year irrespective of his or her normal appointment term.

Recommendation 37
The remuneration committee report should state whether any executive board member or senior executive has the right or opportunity to receive enhanced pension benefits beyond those already disclosed and whether the committee has exercised its discretion during the year to enhance pension benefits either generally or for any member of this group.

Recommendation 38
The remuneration consultants involved in preparation of the draft code of conduct should form a professional body which would assume ownership of the definitive version of the code when consultation on the present draft is complete. The proposed professional body should provide access to the code through a website with an indication of the consulting firms committed to it; and provide for review and adaptation of the code as required in the light of experience.

Recommendation 39
The code and an indication of those committed to it should also be lodged on the FRC website. In making an advisory appointment, remuneration committees should employ a consultant who has committed to the code.

Source: HM Treasury, 2009b

APPENDIX 4 : A SUMMARY OF THE MAIN PROPOSALS OF THE GOVERNMENT'S WHITE PAPER ON FINANCIAL REFORM

AREA OF CONCERN	PROPOSED REFORMS
A. The Governance, Co-ordination and Regulatory Framework of UK Financial Institutions	
(i) Formalising and strengthening the arrangements for institutional co-operation	The creation of a new statutory committee – the *Council for Financial Stability* (CFS) – comprising the Treasury, the Bank of England and the FSA and chaired by the Chancellor of the Exchequer. This Council will replace the current 'Standing Committee'.
(ii) Strengthening the objectives of the FSA	Giving the FSA an explicit *financial stability objective* to add to its existing objectives, as set out in the FSMA.
(iii) Strengthening the FSA's prudential regulation and supervision of banks	The Government endorses Lord Turner's calls for, *inter alia*: • increases in the quality and quantity of capital; • the introduction of a maximum leverage ratio to complement risk-based capital requirements (to include off-balance-sheet items); • a strengthening of liquidity regulation (as set out in FSA, 2008d); and • an enhancement of the FSA's SEP.
(iv) Enhancing the FSA's regulatory powers	Amendment of the FSA's rule-making, 'permission' and intervention powers to allow it to operate in fulfilment of any of its objectives (i.e. including that relating to financial stability). Strengthening the FSA's powers to take action in relation to authorised firms and individuals found guilty of misconduct. Establishing stand-alone (i.e. independent of market abuse) powers for the FSA to take emergency action to place restrictions on short selling and to require disclosure of short selling. Examining the need to extend the FSA's information-gathering powers.
(v) Strengthening the framework for compensation	Introducing an element of *pre-funding* into the deposit-taking sub-scheme of the FSCS. Bringing forward proposals regarding the governance and accountability of the FSCS, while carrying out a similar review of the Financial Ombudsman Service (FOS).

B. Dealing with systemically-significant institutions	
(i) To reduce their risk of failing	Strengthening *market discipline* by using the work of the Walker Review and the FSA's Code of Practice to provide guidance on the standards of discipline in corporate governance and remuneration respectively. The FSA will also be urged to establish and maintain dialogue on governance issues with non-executive members of boards. Enhancing *prudential regulation and supervision* by the FSA through: stricter regulation and supervision of capital and liquidity adequacy, as applied to all authorised institutions; and the imposition of additional capital requirements on systemically-significant institutions, the scale to be dependent on the size and complexity of the firm.
(ii) To reduce the impact of their failure	Strengthening *market infrastructure* (e.g. with respect to CDSs). *Enhancing failure resolution* mechanisms through: the introduction of a new insolvency regime for investment banks, to be provided for in secondary legislation early in 2010, if necessary; and forcing banks to draw up internal failure resolution plans to allow for their speedy resolution if necessary.
C. Managing systemic risk more broadly	
(i) Managing systemic risk across markets and institutions	Enhancing transparency by improving *accounting standards* (the Government strongly supports the recommendations of the FSF in this area – which are due to be implemented by end-2009 – and agrees that the FSA should engage with firms and auditors to ensure more consistent approaches to the valuation of financial instruments across firms). Improving the liquidity, transparency and robustness of *wholesale markets*, and in particular securitisation and over-the-counter (OTC) derivatives markets, through increased standardisation of products, strengthened wholesale market structures, and increasing the amount of due diligence undertaken by investors. Securing a greater *regulatory focus* on systemic risk through enhanced monitoring and supervision and creating a responsive and dynamic regulatory boundary.
(ii) Managing systemic risk over the cycle	The Government endorses the use of the following: • a *maximum leverage ratio* (to complement risk-based capital requirements); • measures, developed by the Basel Committee and the ISAB, to reduce the pro-cyclicality of prudential and accounting standards; • building *counter-cyclical capital buffers* in good times; • measures designed to improve access to funding markets in downturns or crises (forcing debt for equity conversion in the event of a systemic crisis is one

	possibility being considered); and • appropriate discretionary tools to lean against credit cycles, possibly including the resetting of leverage ratios or macro-prudential add-ons to regulatory capital requirements.
D. The international regulatory and supervisory framework	
Strengthening regulation and supervision in Europe	The Government believes the following measures are necessary to further enhance the regulatory and supervisory framework in the EU: • a reduction in the number of national discretions allowable under EU legislation; • a strengthening of the rules and safeguards for cross-border branching within the EEA; • stronger enforcement of EU rules; • the provision of additional resources to the current Level Three committees prior to the establishment of the new European Supervisory Authorities; and • in the longer-term, the creation of a single rule-making body to improve the quality of regulation. At the domestic level, the Government will give the FSA a new statutory duty to promote sound international regulation and supervision.

Source: HM Treasury (2009a)

APPENDIX 5 : A SUMMARY OF THE MAIN PROPOSALS OF THE CONSERVATIVE PARTY'S WHITE PAPER ON FINANCIAL REFORM

Changes to the *regulatory architecture*

- The FSA and the Tripartite system will be abolished, with the Bank of England being given the authority and powers necessary to ensure financial stability.

- The Bank of England will be made responsible for macro-prudential regulation.

- A new Financial Policy Committee will be created within the Bank, working alongside the Monetary Policy Committee, to monitor systemic risks, operate new macro-prudential regulatory tools and execute the special resolution regime for failing banks. The Committee will include the Governor and existing Deputy Governor for Financial Stability in order to ensure close co-ordination between monetary and financial policy.

- The Bank of England to be made responsible for the micro-prudential regulation of all banks, building societies and other significant institutions, including insurance companies.

- A new Financial Regulation Division of the Bank will be created to carry out the micro-prudential role, headed by a new Deputy Governor for Financial Regulation. The work of the Division will be overseen by the 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.

- A new Consumer Protection Agency (CPA) will be created, inheriting the FSA's responsibilities for consumer protection.

- The regulation of consumer credit will be transferred from the Office of Fair Trading to the CPA.

- A single senior Treasury minister will be given responsibility for European financial regulation.

Changes to *regulatory policy*

(i) On the *micro-prudential* front, the following changes to existing policy are proposed:

  - Additional capital and liquidity requirements to be imposed to reflect an institution's size and complexity;

  - "much higher" capital requirements to be imposed on high-risk activities, such as large-scale proprietary trading;

- capital requirements to be used to crack down on risky bonus structures;
- financial institutions to be forced to prepare "living wills" to assist with their orderly wind down in the face of insolvency; and
- the introduction of a "backstop" leverage ratio to constrain bank lending.

(ii) On the *macro-prudential* front, the following new policies are proposed:

- the introduction of counter-cyclical capital requirements; and
- greater central counterparty clearing of over-the-counter securities.

Source: Conservative Party, 2009

APPENDIX 6 : A COMPARISON OF THE REFORM PROPOSALS

	Current System[1]	FSA	Treasury	Bank of England	Conservative Party	Hall
A. Regulatory Architecture						
1. Micro-prudential regulation	FSA	FSA	FSA	FSA	Bank of England ('Financial Regulation Division')	FSA
2. Macro-prudential regulation	-	FSA/Bank of England	?[2]	Bank of England	Bank of England ('Financial Policy Committee')	Bank of England
3. Trigger of SRR	FSA	FSA	FSA	Bank of England	Bank of England	FSA
4. Operational control of SRR	Bank of England	?	Bank of England	Bank of England	Bank of England	New Deposit Protection Agency (DPA)
5. Tripartite system	Standing Committee	Re-constitution of the Financial Stability Committee as a joint FSA/Bank of England Committee	New 'Council for Financial Stability' (comprising existing Standing Committee membership)	?	New 'Financial Policy Committee' comprising Bank of England officials and independent members	Standing Committee
6. Consumer protection	FSA	FSA	FSA	FSA	New 'Consumer Protection Agency' (CPA)	FSA
7. Consumer credit regulation	OFT	OFT	OFT	OFT?	CPA	OFT
8. Deposit protection	FSA (runs the FSCS)	FSA	FSA	FSA?	CPA or possibly the Bank of England	DPA
9. Statutory responsibility for financial stability	Bank of England	?	Bank of England and FSA	Bank of England	Bank of England	Bank of England

	FSA	Treasury	Bank of England	Conservative Party
B. Regulatory Policy				
(I) Micro-prudential regulation				
1. Higher quality and quantity of bank capital	√	√	√	√
2. Higher trading book capital requirements	√	√	√	√
3. Additional capital requirements to reflect size and complexity	√	√	√(?)[3]	√
4. Additional capital requirements to penalise risky bonus structures	√	√	√	√
5. Introduction of a maximum "backstop" gross leverage ratio	√	√	√	√
6. Greater regulatory focus on liquidity	√	√	√	√
7. Institutions to be forced to draft "living wills"	√	√	√	√
8. Deposit protection scheme to be pre-funded	Maybe	√	√	Maybe
9. Deposit insurance "premia" to be risk-related	?	?	√	?
(II) Macro-prudential regulation				
1. The introduction of counter-cyclical capital and liquidity requirements	√	√	√	√
2. The introduction of counter-cyclical accounting measures (e.g. to reduce the pro-cyclicality of fair value accounting)	√	√	?	?

	FSA	Treasury	Bank of England	Conservative Party
(III) Other safeguards				
1. Greater regulation and tighter monitoring of credit rating agencies	√	√	√	√
2. Greater use of central counter-party clearing for standardised derivative contracts (incl. CDSs)	√	√	√	√
3. Improved accounting standards (e.g. in relation to the valuation of financial instruments)	√	√	√	√
4. The regulatory perimeter should be extended to include all systemically-important firms (incl. hedge funds) according to the principle of economic substance not legal form	√	√	?	?
5. Offshore financial centres to be covered by global agreements on regulatory standards	√	√	?	?
6. Remuneration policies to be subject to internationally-agreed Codes	√	√	√	√
7. Stronger corporate governance arrangements enforced through Codes	√	√	√	√
8. Enhancing failure resolution mechanisms through, for example, the introduction of a new insolvency regime for investment banks	?	√	?	√

	FSA	Treasury	Bank of England	Conservative Party
9. Enhanced international co-ordination of supervision of cross-border banks through, for example, the establishment of colleges of supervisors, the pre-emptive development of crisis co-ordination mechan-isms and contingency plans, and the harmonisation of failure resolution regimes	√	√	√	√
10. Increased powers for home supervisors (e.g. to be able to require local subsidiarisation) under the EU Single Market for financial services	√	√	?	√
11. Extending market discipline through, for example, using the work of the Walker Review and the FSA's Code of Practice to provide guidelines on the standards of discipline in corporate governance and remuneration respectively. [Regulatory-enforced debt for equity swaps under failure resolution mechanisms might also be employed; and principles governing the nature of public intervention need to be looked at again to minimise moral hazard.]	√	√	√	√

Footnotes:
1. Under the Financial System and Markets Act 2000 and the Banking Act 2009.
2. A '?' denotes the absence of a clear statement on the policy/principle concerned.
3. The Governor has also raised the possibility of introducing more formal structural solutions.

Endnotes

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[i] 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.]

[ii] For further details *see* Hall, 2009a.

[iii] For a critique of these schemes *see* Hall, 2009b.

[iv] A review and assessment of these proposals is provided in Hall, 2009a.

[v] The 'Turner Review' – *see* FSA, 2009a (and the accompanying discussion paper – FSA, 2009b).

[vi] *See* HM Treasury, 2009a, and Conservative Party (2009), respectively.

[vii] 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).]

[viii] 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.

[ix] 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).

[x] Although this is clearly desirable, it is not without serious practical difficulties – *see* Gerlach and Gruenwald, 2005.

[xi] 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.

[xii] 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.

[xiii] These floors determine the maximum reductions in required capital, relative to Basel I, allowed under Basel II.

[xiv] 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!

[xv] 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.

[xvi] 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).

[xvii] 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.

[xviii] *See*, for example, the Committee of European Bank Supervisors (2009) and FSB (2009b).

[xix] No doubt wary of derailing one of the few surviving "gravy 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".]

[xx] 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.

[xxi] 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.

[xxii] The self-evident need to improve the market infrasture 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.

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

[xxiv] 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).

[xxv] 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.

[xxvi] 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).

[xxvii] 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.

[xxviii] 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.

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

[xxx] 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.

[xxxi] 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.

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

[xxxiii] 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.

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

[xxxv] 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.

[xxxvi] 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.]

[xxxvii] 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.

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

[xxxix] 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.

[xl] 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.

[xli] 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.

[xlii] 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).

[xliii] 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.

[xliv] 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.

[xlv] 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'.

[xlvi] 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.

[xlvii] 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.

[xlviii] A task which it believes the new European Supervisory Authorities should take on board.

[xlix] 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.

[l] 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.

[li] 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.

[lii] 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.

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

[liv] 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.

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

[lvi] 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.

[lvii] 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.

[lviii] 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 re-distribution (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.

[lix] 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.

[lx] 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.

[lxi] 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.

[lxii] Industry squeals about the increased intensity and scope of current practice are testament to this.

[lxiii] 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).

[lxiv] 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.

[lxv] *See* HM Treasury, 2009a, Section 6, para.6.60.

[lxvi] 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).

[lxvii] 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.

[lxviii] 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.]