

Financial Regulation in the United Kingdom: Historical Foundations and Current Practices

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Abstract

Financial markets have been developed rapidly in recent years. New and sophisticated financial tools have been the cause of these developments which need new controlling systems to prevent crisis. Most of industrial economies have reformed regulatory structure of their financial systems.

This paper reviews the regulatory developments of UK in this regard and offers new regulations and accounting standards concerning financial activities. These regulations have undergone significant structural financial reforms over the past three decades principally aimed at changing the architecture of the financial sector and encouraging greater competition. These reforms offer a unique setting to explore empirical evidence from experiments with competing theories of regulation; that is, studying the real world challenges and the pros and

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cons of self-regulation on the one hand and state intervention and public regulation on the other.

One of important issues considered here is the contagious effects of crises from sector to sector, and from country to country which should be prevented by new effective regulations. Monitoring financial firms and their scale and domain of economic activities can prevent or reduce this domino effect.

Key words: *financial authority, statutory objectives, systematic risk.*

Jel Classification: *G18, G28, E42.*

1. Introduction

Over the past two decades, financial markets in different industrialised and emerging economies have developed significantly. This path of change is evident in respect to emerging innovations in intermediaries, capital markets and financial instruments. Structural changes have mainly involved the more traditional financial operators in banking, but have also focused on investment firms and insurance companies. In response to such developments and the changing nature of the financial sector, the regulatory and supervisory arrangements of financial systems have also been modified. Indeed, the topic is still at the heart of a lively debate, and countries such as the United States, the United Kingdom, Australia, Germany, France and Japan are currently either undertaking or implementing reforms in the regulatory structure of their financial systems.

The main objective of this paper, however, is to present a historical overview of regulatory developments in the financial sector of the United Kingdom; that is to examine the UK experience with the formulation and establishment of a set of specific rules of behavior that financial firms have to abide by.

The UK is selected for examination for various reasons. London is a leading international financial centre. It has undergone significant structural financial reforms over the past three decades principally aimed at changing the architecture of the financial sector and encouraging greater competition. These reforms offer a unique setting to explore empirical evidence from experiments with competing theories of regulation; that is, studying the real world challenges and the pros and cons of self-regulation on the one hand and state intervention and public regulation on the other. The UK regulatory model has served as a model for many countries seeking to establish new regulatory structures. It has been successfully adopted and implemented in various countries around the world such as Hong Kong, Canada and Australia. Lessons learned

from these experiences can be of particular value and relevance to those countries where plans to reform the structure of regulation and supervision within the financial and banking systems are currently underway, an example of which is Iran.

2. Economic Foundations for Financial Regulation

Failures are the most obvious manifestation of unsafe and unsound financial systems. As Goodhart *et al.* (1998) note, it is not surprising then that the financial service industry is one of the most regulated industries in the world, and the rules that apply to financial intermediaries are one of the most prominent aspects of financial sector regulation. This prominence results from the central role that intermediaries play in the facilitating economic activity and the importance of financial institutions for the overall soundness of the financial system. But what is financial regulation and what are the sources of demand for the presence of regulatory agencies?

Regulation can be generally defined as using legal instruments to implement goals of social and economic policies. In a financial context, Llewellyn (1996) defines regulation as the supply of regulatory and supervisory services where the former is defined as prescriptive and the latter involves the exercise of allowable discretion, even when both services may be supplied through the same agency involving a trade-off. The presence of regulation has been justified on different bases. For example, according to Dale and Wolfe (2003), the case for regulation in the financial sector can be made on grounds of consumer protection, reducing information asymmetric information and ensuring the integrity of financial markets. Llewellyn (1999), however, emphasises seven components of the economic rationale for regulation and supervision in banking and financial services. These components encapsulate the various arguments discussed in the financial and economics literature for justifying regulation and include the following seven arguments:

(a) Resolving potential systemic problems associated with *externalities* as a particular form of market failure. The key systemic point is that financial firms (e.g., banks) are potentially subject to runs, which may have contagious effects. The main externality here is that the failure of an insolvent firm can cause depositors and investors of other (solvent) firms to withdraw their funds. The existence of adequate regulatory mechanisms such as deposit insurance schemes and the lender of the last resort can mitigate the systemic risks of failures.

(b) Correcting for other *market imperfections and failures*. The market imperfections and failures prevalent in financial services create a role for regulation. These include, among others, inadequacy of information on the part of consumers, asymmetric information conditions due to consumers being less well-informed than the suppliers, agency costs, principal-agent problems and issues related to conflicts of interest, quality uncertainty, consumers inability to assess the safety and soundness of firms except at an inordinate cost leading to a public good role for regulation and free-rider problems where all consumers assume that others have investigated the safety of the financial firm.

(c) *Monitoring* of financial firms and the economies of scale that exist in this activity. The nature of financial contracts between firms and their customers calls for continuous monitoring of behavior. Customers are unable to undertake such monitoring and delegate this important role to regulatory agencies. In effect, the regulator is viewed as supplying monitoring services to customers and in this process, potential economies of scale are secured through the collective authorisation and supervision and monitoring of financial firms.

(d) Establishing consumer *confidence* which also has a positive externality. The presence of regulation and regulatory agencies offers consumers independent assurance about the terms on which financial contracts are offered, the safety and soundness of assets which underpin them and the quality of advice received from financial firms, thereby

encouraging economy-wide saving and investment and creating favourable economic consequences.

(e) Resolving the potential for *gridlock* and the associated adverse selection and moral hazard problems. A *gridlock* can emerge when all firms know how they should behave towards customers but adopt hazardous strategies to secure short-term advantages, and they have no confidence that competitors will not behave hazardously. In such a situation two problems can emerge: *adverse selection* and *moral hazard*. Regulation can play a beneficial role in breaking a *gridlock* by offering a guarantee that all firms will behave within certain standards.

(f) Minimizing the *moral hazard* associated with the revealed preference of governments to create safety net arrangements such as the lender of the last resort, deposit insurance and compensation schemes. Regulation can be constructed so as to remove the probability that the moral hazard involved with insurance and compensation schemes will be exploited. This may take the form of prescriptions to influence the behavior of the insured. In addition, it is reasonable that the ultimate payers of compensation have some say in the behavior of the insured institutions.

(g) Responding to *consumer demand* for regulation in order to gain a degree of assurance and lower transactions costs. There are several reasons why it can be rational for the consumer to demand regulation. Regulation can lead to lower transactions costs for the consumer. It can also be beneficial to those who lack information or the ability to utilise information. Private demand for regulation is also a function of customers desire for a reasonable degree of assurance in transacting with financial firms and their past experience of bad behavior by financial firms.

The arguments favoring regulation lead to two types of regulation as noted in Llewellyn (1999): (a) *prudential regulation*, which focuses on the solvency, safety and soundness of financial institutions and (b) *conduct of business regulation*, which focuses on how financial firms

conduct business with their customers. The case for prudential regulation is well documented within financial literature. The arguments emphasise the fact that consumers are generally not capable of judging the safety and soundness of financial firms. Prudential regulation is therefore necessary due to imperfect consumer information, agency problems arising from the nature of financial firms' activities, and because the behavior of a firm after consumers have dealt with it affects the value of their stake. No amount of information at the time of contracting protects against subsequent behavior of the firm. Regardless of the potential systemic dimension, there is therefore a case for prudential regulation when: (a) the financial firm acts on behalf of consumers and carries out a fiduciary role, (b) consumers are incapable of adequately assessing the safety and soundness of financial firms at the time of contracting, (c) post-contract firm behavior affects the value of contracts and (d) there is a potential claim on a deposit insurance fund or compensation scheme because the costs of hazardous behavior of a financial firm can be passed on to others.

The nature of conduct of business regulation, on the other hand, relates to how firms conduct business with their customers. It emphasises such areas as the mandatory disclosure of information, the honesty and integrity of firms, their directors and their employees, the competence of firms offering financial services and products, establishment of fair business practices in the financial industry and the ways by which financial products and services are marketed. Conduct of business regulation can also establish guidelines for the objectivity of advice, with the aim of minimizing principal-agent problems that can arise when principals and agents either do not have equal access to information, or do not have equal expertise to assess it. Overall, conduct of business regulation is designed to establish rules and guidelines about appropriate behaviour and business practices in dealing with customers.

The responsibility for financial regulation and supervision can be structured in different ways and can span from the concentration of all activities in just one body, the single regulator, to their distribution among a number of agencies. In turn, this distribution can be summarised on the basis of three different principles which are the distribution by purpose, distribution by function/sector, and the existence of a single regulatory body. The first, also known as the *twin peaks principle*, refers to the two primary objectives of the regulator noted above: prudential regulation, which is primarily concerned with the financial soundness of the regulatees, and conduct of business regulation, which focuses on the ways in which financial products are marketed and sold (Taylor, 2000a). Regulation and supervision by function/sector, on the other hand, refers to the sectors of activity in which the regulatees operate, mainly in banking, insurance and securities. Another very important factor is the allocation of regulatory and supervisory functions to the central bank. In relatively recent times, emphasis has been placed on the latter's responsibility for ensuring macro-economic stability, especially where responsibility for stability at the micro level has been allocated elsewhere. Regardless of methods for distributing responsibilities, the role of the central bank may range in its extension, but it is never totally out of the regulation and supervision perimeter. At the same time and as Ciocca (2001) reports, the allocation of regulatory and supervisory powers is influenced by a number of relevant aspects, which include the country's legal tradition and hence the constitutional and institutional framework within which the matter is set; the reputation, independence and adequacy of the resources of the institutions involved in supervision; and the market's perception of these institutions.

Over the past three decades, Britain has had a history of adopting from the different modes of regulatory and supervisory structures. However, the choice since the late 1990s has been the single regulator model and a role of macro-systemic supervision has been attributed to

the Bank of England which has also retained the responsibility of acting as the lender of the last resort. As discussed in the next sections, the choice of a single regulator for the UK's financial system has been based mainly on considerations of cost-effectiveness, economies of scale and scope, on the opportunity of a uniform approach to regulation and on consumer protection and financial crime prevention.

3. Financial Regulation and Supervision in the UK: An Introduction

The financial system currently observed in the United Kingdom together with its relatively complex regulatory and supervisory structure and enforcement mechanisms are collectively considered as one of the most developed models of financial architecture in the world. However, quite surprisingly, up to the beginning of the 1970s, the banking system of Britain was at best fragmented, comprising groups of deposit banks, secondary banks and the so-called near-banks. The fragmentary nature of the banking system was matched by an equally fragmentary structure of the supervisory bodies. An interesting observation is that the literature on banking at the time did not even make a single mention of *supervision* or *regulation* (Sayers, 1967; Revell, 1973). The Bank of England was responsible for the banking system's stability. It acted as the lender of the last resort and also imposed certain minimum thresholds for asset ratios on the deposit banks. But its powers of supervision were few and it had an inclination towards more reliance on informal agreements with the banks. The main concern was that these agreements did not focus so much on ensuring systemic stability as they did on delivering an efficient government securities market and implementing the Bank's credit policy (Collins, 1988). An only slightly different opinion at the time contended that the central bank's interest in maintaining the stability of the banking system could be linked to its responsibility as the government banker and to its consideration of deposit banks as clients towards which it had a

protective duty (Sayers, 1976). There was also no organised oversight structure for the banking sector's most dynamic segment, the secondary banks¹. The state of regulation in the 1960s, which was extremely disjointed and erratic, helps understand not only the dynamics of the three segments of the banking industry (deposit banks, secondary banks and near-banks) in the 1960s, but also the series of regulatory reforms that affected the banking system in the United Kingdom from the early 1970s onwards.

In the absence of adequate supervision from the Bank of England, secondary banks had managed to collect large amounts of unsecured funds which had been used mainly to provide finance, including long-term loans, for the construction of non-residential property, a market that was booming in those years. The removal of quantitative limits for banks in 1971, coupled with the expansionary monetary policy despite the high point of the cycle, fuelled a speculative bubble in the building sector. This concentration together with the increase in the discount rate in 1973 led to a problem of maturity mismatching for many secondary banks and in just a matter of few months, house prices and the share market crashed. Many secondary banks failed and were bailed out through the intervention of the Bank of England. After many years of stability, the crisis of the secondary banks set the stage for widespread reforms to the structure of supervision, previously characterised by the informal model of the Bank of England with considerable room left for self-regulation. From the 1970s onwards, the strong drive for innovation in the system and the crisis of the secondary banks revealed the discrepancy between the financial systems changing nature and a static regulatory regime. After the secondary banks' crisis², in 1974, the reporting requirements to

1- Secondary banks primarily comprised accepting houses, overseas banks and foreign banks. The common factors distinguishing them from deposit banks were their lack of direct access to the payment system and clearing arrangements and that they took the majority of their deposits from the wholesale market rather than the retail market. International Financial Services London.(2006). International Financial Markets in the UK. *City Business Series*, November: 8.

2- For more information on the secondary banks' crisis, see: Reid, M. (2003). *The Secondary Banking Crisis* (London: Hindsight Books Ltd.).

the Bank of England were stiffened and the scope of regulation was widened. In fact, in a statement released in 1978, the Bank of England admitted how little financial activity had been subject to regulation and to what a large extent it had relied on non-statutory regulation and self-regulation.

A regulatory earthquake occurred in 1979. The Banking Act 1979 (amended 1987) followed by the Financial Services Act 1986 were passed as regulatory responses to what is commonly referred to as the *Big Bang* era in the City of London. These two Acts extended the supervisory powers of the Bank of England to the secondary sector and formalised the supervision process in the primary sector, thus creating a kind of two-tier system with the lower tier consisting of Self-Regulatory Organisations (SROs) that imposed behavioral control upon their respective members and reported to the Securities and Investment Board (SIB), the upper tier, which was essentially an umbrella organisation with statutory powers. Together, they were responsible for ensuring the proper conduct of business by the investment community. In addition to the SROs and the SIB, three prudential regulators, the Bank of England, the Building Societies Commission and the Department of Trade and Industry were also involved. Self-regulating bodies were considered to be the best judges of the standards and rules of conduct for their members because they were more informed about the operations of the financial business. In fact, the main argument for self-regulation was that state regulators would always have less information. It was also argued that public regulators could develop a close relationship with the regulatees, causing laxity in their enforcement of regulations, and in some instances, a vested interest in trying to protect insolvent firms from closure, known as *regulatory capture* (Fischer, 2009). Self-regulation would prevent this problem from arising. However, a counter argument was that although there is ample evidence of this problem occurring

among state regulators, there is no reason why it may not occur under self-regulation. In fact, cynics often argued that SROs and the firms they regulate are in fact more like a club. Although the SROs may have had better information with which to draw up an efficient set of regulations, their enforcement powers were minimal as the legal system had granted statutory powers only to the SIB. The assertion that then followed was that public regulators could resolve the information problem by hiring individuals with extensive experience in the relevant financial business. But lower salaries in the public sector made it quite difficult to attract the best expertise. Another potential problem was that self-regulation encouraged collusive behaviour among firms because of the close connections between the practitioners who regulated and the regulates. The increase in the number of financial conglomerates is also cited as a factor which favors state regulation. Under self-regulation, conglomerates faced costly compliance ° having to satisfy the requirements of multiple regulators rather than just one single authority. But this point is more of an argument in favor of a single, and not necessarily state, regulator.

By 1997, change in the regulatory structure was the central theme again and supervision was divorced from the central bank, and a monolithic single regulator emerged. It is difficult to identify a single, major cause for change in the regulatory framework. The closure of the Bank of Credit and Commerce International (BCCI) in 1991 and the collapse of Barings in 1995 had questioned the supervisory abilities of the Bank of England, but they were not necessarily cited as the main sources of demand for change. There is also no evidence of collusion between the Bank of England and regulated banks. However, practitioners and regulators alike had recognised that the system had become increasingly cumbersome and rather ill-fitted to financial firms which had to answer to more than one of the SROs. There were cases

where a major bank could find itself having to report to the Bank of England, comply with the rules set by different SROs and answer to other prudential regulators. As Briault (1999) argues, several factors appear to have contributed to the reform. Amongst these was the emergence of complex financial conglomerates mainly as a result of the removal or weakening of barriers to entry and of restrictions on diversification and on various types of ownership structures together with increased levels of innovation and technological progress, greater competition and internationalisation. The ultimate outcome was a blurring within the financial services sector of traditional distinctions which used to apply across types of firms, types of products and types of distribution channels. The absence of conjunction between particular types of firms and a clearly-defined range of products implied that regulation on a functional self-regulatory basis, which was promoted during the 1980s, would no longer be feasible.

In a similar vein, Goodhart *et al.* (1998) argue that the emergence of financial conglomerates challenged the traditional demarcations between regulatory agencies and Taylor (1996) finds that the boundaries between regulators no longer reflected the economic reality of the financial industry. In May 1997, the Chancellor of the Exchequer, Gordon Brown, announced that the Bank of England was to be independent of the Treasury. In less than a fortnight, an end to self-regulation by function was announced. Responsibility for all aspects of financial regulation (prudential regulation and conduct of business regulation) was handed over to the single state regulator, the Financial Services Authority (FSA).

4. A New Regulatory Framework: The Financial Services Authority

Based on the Banking Act 1998, the Bank of England's supervisory and related powers were transferred to the newly created Financial Services

Authority (FSA). The choice of a single regulator in the UK is basically based on considerations of cost-effectiveness, economies of scale and scope, on the opportunity of a uniform approach to regulation and on consumer protection and financial crime prevention (Gola and Roselli, 2009). The stability issue is not damaged in the legislator's view as the Bank of England, despite its short-life role as prudential regulator, still continues to share responsibility for financial stability, with the FSA and HM Treasury under a Tripartite Memorandum of Understanding (MOU) signed in 1997. It is this Memorandum and not statutory legislation that makes the Bank of England responsible for the macro-stability of the financial system.

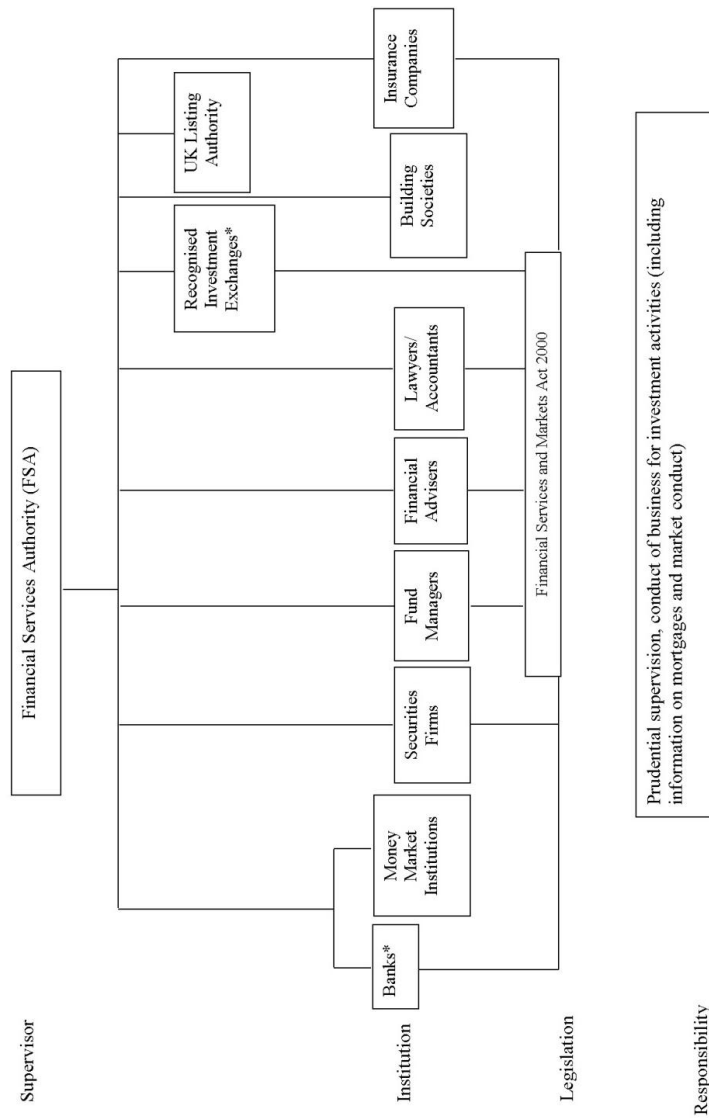
According to the MOU, the division of responsibilities amongst the three pillars of regulation and supervision is based on four guiding principles. These include: (a) *clear accountability* which means that each institution has to be accountable for its actions, and should therefore have unambiguous and well-defined responsibilities, (b) *transparency*, so that Parliament, markets and the public knew who was responsible for what, (c) *no duplication*, so as to avoid second guessing, inefficiency and duplication of effort and (d) *regular information exchange*, so that each institution would be helped to discharge its responsibilities efficiently and effectively. Based on the MOU, the Bank of England contributes to the maintenance of the stability of the financial system as a whole by ensuring the stability of the monetary system and overseeing financial system infrastructure in general and the payments system in particular. The FSA, on the other hand, is responsible for the authorisation, and, where applicable, the prudential regulation of all financial institutions and the supervision of clearing and settlements and financial markets. Finally, the Treasury has responsibility for the overall institutional structure of financial regulation, informing and accounting to Parliament for the management of serious problems in the financial system and

measures to resolve them, and accounting for financial sector resilience to operational disruption within the government (MOU, 1997).

The MOU also outlines the process of information gathering and information sharing between the three regulatory bodies. The main forum for cooperation between the Bank of England, the FSA and the Treasury is the Tripartite Standing Committee on Financial Stability, which meets once a month to discuss cases of potential systemic significance and the consequences of potential risks in terms of financial stability. According to an amendment agreed in 2006, ultimate responsibility for authorising support operations in serious crises, as that of the current credit and financial downturn, lies with the Treasury. As part of the institutional linkage between the FSA and the Bank of England, the Chairman of the FSA is a member of the Bank's Court of Directors and the Bank's Deputy Governor for Financial Stability is a member of the FSA's Board.

The objectives and principles to be followed by the FSA are determined by the Financial Services and Markets Act 2000 (FSMA) which established the FSA as the sole regulator of all UK financial institutions. According to the FSMA, the FSA is bound, by statute, to: (a) maintain confidence in the UK financial system (this is normally interpreted as equivalent to maintaining the stability of the financial system, see Taylor, 2000b), (b) educate the public (the so-called *caveat emptor*)^o with special reference to the risks associated with different forms of investing, (c) protect consumers but encourage them to take responsibility for their own financial decisions and (d) reduce financial crime (e.g. money laundering, fraud and market manipulation, including insider dealing).

Figure (1) UK Financial Regulatory Structure Summary



* includes recognised clearing houses
 Source: Jackson, P. (2000). "Unified Supervision: The UK Experience." Financial Regulator 5(3): pp. 50-59.

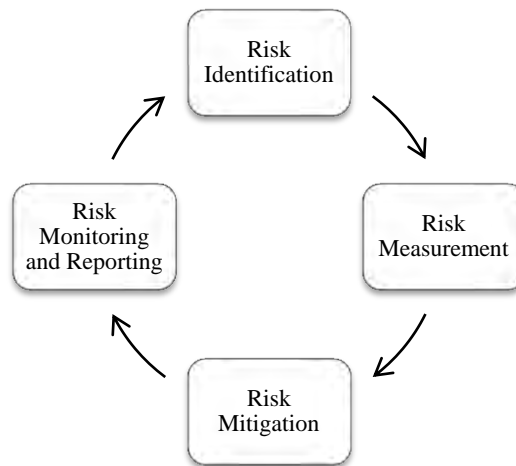
In pursuing its statutory objectives under the FSMA, the FSA must act in accordance with the six principles of good regulation. These principles are: (a) efficiency and economy, (b) role of management, (c) proportionality, (d) innovation, (e) international character and (f) competition. Stated otherwise, based on these principles the FSA must use its resources in the most efficient and economic way. It must respect the autonomy of management and responsibilities of firms subject to supervision and not interfere with them. The FSA must also ensure that its supervision is proportionate to the benefits that are expected to result from it. It must facilitate innovation and work towards maintaining the competitive position of the United Kingdom in financial services and markets at the international level. And finally, the FSA must minimize the adverse effects of its activities on competition and facilitate competition between the financial firms it regulates. In regards to the UK financial competitiveness, the FSA emphasises that this ought not to be confused with a role of promoting London as an international financial centre, a role that does not pertain to them. Similarly, the FSA is inclined not to accept ° or at least to qualify ° *light regulatory touch*, preferring to speak of a risk-based and principles-based approach (accompanied by a cost- benefit analysis of the regulation), that does not necessarily reflect a lighter weight on the supervised person.

As noted above, the supervisory style of the FSA can be succinctly described with two expressions: *risk-based* and *principles-based*. Taking the first expression, in light of the four objectives set forth in the FSMA and the principles that the FSMA establishes to guide the FSA s action, all regulatory and supervisory activities are planned in terms of the *risk of not being able to achieve the statutory objectives*. The FSA s task, therefore, is to identify and mitigate the risks in the financial system, bearing in mind its own limited resources, informational uncertainty and the costs of its measures both for itself and for intermediaries.

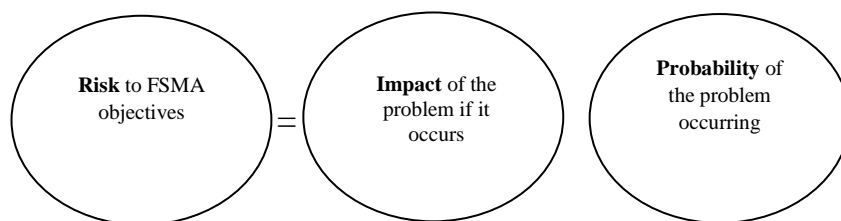
The regulatory approach of the FSA is described as *risk-based*, that is proportional to the riskiness of the regulated, where the intensity of the risk is measured on the basis of the probability that a problem occurs, and on the impact that the firm's problem may cause in the financial system. The other approach of the FSA is *principles-based*, an approach that seems still underway and that has to be reconciled with the detailed regulatory framework set up by the statutory legislation.

The operational tool with which the FSA implements its risk-based approach is called ARROW (Advanced, Risk-Responsive Operating framework), which was revised in 2003 (ARROW II) and later explained in a paper published in 2006 (FSA, 2006). ARROW provides the practical link between the statutory objectives outlined in FSMA and the FSA's regulatory and supervisory activities. It is designed to identify the main risks to the FSA's objectives as they arise, measure their importance, mitigate them where their size justifies this and to monitor and report on the progress of the FSA's risk management. This ARROW cycle is presented in Figure 2 below.

The first stage is to identify the risks to the statutory objectives. This is done through intelligence gathering from a variety of sources (e.g. through visits to financial firms; information provided by firms on request or by firms' own initiative; monitoring of regulatory returns and similar data; transaction monitoring; sector and environmental analysis; project work; etc.). The next stage is to measure the risks. This involves scoring the risk against several probability and impact factors which could be weighted as high, medium-high, medium-low or low. The probability factors relate to the likelihood of the event happening, and the impact factors indicate the scale and significance of the problem if it were to happen.

Figure (2) Risk-based Regulation- The ARROW Model

Combining the probability and impact factors gives a measure of the overall risk posed to attaining the statutory objectives. This is presented in Figure 3. The FSA's measure of the overall risk is then used to prioritise the risks, help make decisions on the regulatory response and, together with an assessment of the costs and benefits of using alternative regulatory tools help in determining resource allocation. Finally, risk management systems provide management with regular reports to give assurance that risks are being managed appropriately and that internal controls are adequate.

Figure (3) Risk Measurement by the FSA

Implicit in the risk measurement process of the FSA are several general factors that are taken into account in regulatory and supervisory actions. First, there is a non-zero failure assumption in place. Second, the great number of firms being regulated and supervised makes it necessary for the FSA to differentiate the level of intensity of supervision. Third, there is a need for the FSA to harmonise supervisory instruments that were in place before its creation but were scattered amongst different authorities. Therefore, in principle, the FSA does not differentiate its approach by category of financial intermediary, but rather concentrates on each regulatee's risk. The impact of a risk and the probability of its occurring are thus the key factors in the FSA's analysis. The risk to FSMA objectives determines a firm's impact score which in turn will determine how closely the FSA monitors it. If the impact score is low, then the firm is likely to be monitored through the completion of various checklist forms, while a high impact firm will require continuous meetings and regular visits made by the FSA. A firm's score could vary from A (very high risk) to D (low risk). The risk is not confined to the risk of financial instability, but any risk that might prevent the FSA from meeting its statutory obligations. In respect to the impact of a potential problem, such elements as the seriousness of the problem, the financial firm's size and its perceived importance are considered. On the other hand, under probability, the FSA emphasises two main risk factors, *business risk* and *control risk*, which it has further classified into ten specific groups. Therefore, business risk comprises: environmental risks; customer, product and market risks; business process risks; and prudential risks. By contrast, control risk refers to: customers, products and markets; financial and operating controls; prudential risk controls; control of management, governance and culture; control functions (compliance and audit); and capital and liquidity adequacy. Within each of these ten groups, the FSA has identified other risk elements in more detailed or granular fashion. For example, risks associated with legislation, the degree of competitiveness and the efficiency of the

capital market are external to the firm and therefore are classified under environmental risks; those associated with retail customers and retail financial products fall under customer, product and market risks; legal risk goes under business process risks; and credit, market, operational, liquidity and insurance underwriting risks are classified as prudential risks (FSA, 2006).

In assessing probability for the firm, the FSA considers each of the ten risk groups separately and uses the ARROW model to obtain an overview of how they interact within the firm. Combining the risk groups according to a grid, an FSA analyst arrives at an assessment of net probability. The resulting scoring is as presented in Table 1 and will determine the FSA's overall approach and the intensity of its response.

Table (1) Risk Groups based on Impact and Probability

| Impact | Probability |
|---------------|--------------------|
| High | High |
| Medium-high | Medium-high |
| Medium-low | Medium-low |
| Low | Low |

Risk analysts at the FSA apply this model on a cyclical basis with an adjustment period that spans between one and four years between rounds of assessment. This may appear to be a rather long interval, but the FSA interacts frequently, sometimes even on a weekly basis, with high-impact firms in such forms as exchanging information, requesting documents and holding sectoral meetings with corporate officers and managers. For large firms, the analysis is conducted separately by business unit and then combined in a consolidated group-wide assessment. While the FSA

assigns a relationship manager to each of the largest firms, it deals with those it classifies as small firms through its Firm Contact Centre. Small firms are subject to occasional evaluation, mainly on specific issues that have been flagged as priority concerns on the basis of distance controls or information from the Financial Ombudsman Service¹ and other sources. Small firms, however, are affected by the FSA's thematic work, which means setting up a specialist project team who would analyse a general theme (debt and affordability, for example), possibly coming from new or unexpected developments, and also visiting a sample of small firms to gauge the size of the problem in the financial industry. By contrast, for the more complex firms, validation of the results of analysis is performed by committees composed of FSA staff. In view of the diversified set of firms that it supervises, the FSA has developed three approaches of differing intensity in applying the Arrow II model as follows:

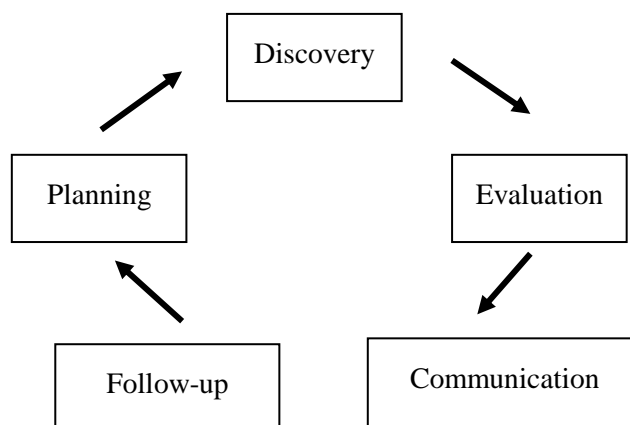
1. *Full-ARROW*- a full risk assessment of probability (all business risks and control risks) within the firm;
2. *ARROW Light*- a reduced-scope risk assessment (matching the relatively low level of resources available), covering certain core areas and sectorally-important issues only, unless other clearly identified significant risks need attention; and
3. *Model for small firms*- reserved to intermediaries judged to be low impact.

The Full-ARROW and the ARROW Light processes involve a series of structured stages that are designed to ensure that the FSA gathers the information needed to form a view of the risks and controls within the firms in question. They also focus the supervisor's attention on the risks that matter most and then help in devising a Risk Mitigation Programme (RMP) to address these risks. The stages of the process include the

1- The Financial Ombudsman Service is an independent UK expert body for settling individual complaints between consumers and businesses providing financial services. For more information, see: <http://www.financial-ombudsman.org.uk/>

planning phase, discovery, evaluation, communication to firms and follow-up, after which a new round of assessment begins. The supervisory assessment cycle is shown in Figure 4.

Figure (4) The FSA Risk Assessment Cycle



Turning now to the FSA's other approach, principles-based regulation; the underlying idea is to focus on the outcome rather than focusing on compliance with the rules, which may concentrate on symptoms rather than causes of market problems (Conceicao and Gray, 2007). Starting from a very detailed regulatory framework, this approach marks a significant development. The details of the regulatory approach of the FSA are defined in the FSA Handbook. Any firm intending to be authorised directly by the FSA will be subject to the provisions set out in the FSA Handbook¹. The Handbook is made up of a number of different provisions and contains all of the FSA's legislative and other provisions made under powers given to it by the Financial Services and Markets Act 2000. The Handbook, by the FSA's own admission, is an extensive document although in practice, most users will only refer regularly to the specific parts of the Handbook relevant to their particular business.

¹The Financial Services Authority Handbook is available for online viewing at: <http://fsahandbook.info/FSA/html/handbook/>

The Handbook is divided into Blocks with each Block being subdivided into modules. These blocks are:

High Level Standards (Block 1)

Block 1 deals with the overarching requirements for all authorised persons (firms) and approved persons... The Standards include eleven general principles for businesses on the basis of the four objectives and the rule-making power assigned to FSA by the FSMA. They are the foundation for the other rules and guidance for firms found in other sections of the Handbook and hence, they will be examined in more detail here. The eleven Principles for Businesses are as follows:

1. *Integrity*: A firm must conduct its business with integrity.
2. *Skill, care and diligence*: A firm must conduct its business with due skill, care and diligence.
3. *Management and control*: A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4. *Financial prudence*: A firm must maintain adequate financial resources.
5. *Market conduct*: A firm must observe proper standards of market conduct.
6. *Customers' interests*: A firm must pay due regard to the interests of its customers and treat them fairly.
7. *Communications with clients*: A firm must pay due regard to the information needs of its clients, and communicate information with them in a way which is clear, fair and not misleading.
8. *Conflicts of interest*: A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. *Customers: relationships of trust*: A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.

10. *Clients' assets*: A firm must arrange adequate protection for clients' assets when it is responsible for them.
11. *Relations with regulators*: A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

The High Level Standards also outlines the FSA's management requirements for the firms it regulates. These are commonly referred to as Senior Management Arrangements and Systems and Controls and focus on the responsibilities of directors and senior management to ensure the firm has appropriate control, supervision and accountability systems in place, including appropriate operational risk systems and controls. Also included in Block 1 are the Threshold Conditions and the Statements of Principle and Code of Practice for Approved Persons. The Threshold Conditions set out the minimum statutory conditions which a firm is required to satisfy, and continue to satisfy, in order to be given and to retain authorization. The Statement for Approved Persons, on the other hand, describes the standards of behavior that the FSA expects of approved persons. The Code of Practice outlines the behavior which, in the FSA's opinion, will or will not comply with a Statement of Principle...

The Fit and Proper Test for Approved Persons is also set out in the High Level Standards of the Handbook. The Test represents the FSA's minimum standards for becoming and remaining an approved person. These standards are relevant when a firm submits an application for an employee or other person to become an Approved Person and for the purposes of assessing the continuing fitness and propriety of approved persons. The FSA will have regard to a number of factors when assessing the fitness and propriety of a person to perform a particular controlled function.

Prudential Standards (Block 2)

Block 2 sets out the prudential requirements that will affect firms.

Business Standards (Block 3)

Block 3 sets out most of the requirements that will affect firms' day to day business activities. It also outlines rules and guidance on holding client assets and client money, including requirements as to segregation and safe custody of assets and statutory trusts in respect of client money.

Regulatory Processes (Block 4)

Block 4 consists of modules describing the operation of the FSA's supervisory and disciplinary functions and containing requirements on firms relating to the supervisory function and sets out, the FSA's decision-making procedures.

Redress (Block 5)

Block 5 contains three modules dealing with the processes for handling complaints and compensation...

Specialist Sourcebooks (Block 6)

Block 6 contains specialist modules, which show how the Handbook applies to certain sectors, such as collective investment schemes and credit unions and includes a module dealing with issues for firms arising out of the EU Electronic Commerce Directive.

Listing, Prospectus and Disclosure Rules (Block 7)

Block 7 contains three modules which set out the requirements for issuers listed on, or seeking admission to, the Official List of the United Kingdom Listing Authority (UKLA)¹, rules that apply to a sponsor and a person applying for approval as a sponsor, along with the prospectus and disclosure document requirements.

In addition to the generic Handbook, there are also 14 sector-specific Tailored Handbooks of rules and guidance for smaller firms. Before relying on a Tailored Handbook, however, a firm needs to satisfy itself that it matches the attributes listed for that Tailored Handbook and if it does not, should use the full Handbook.

1- The FSA, when it acts as the competent authority under Part VI of FSMA, is referred to as the UK Listing Authority or UKLA. In this role, the FSA is a securities regulator, focused on the companies which issue the securities traded in financial markets.

5. The FSA: Enforcement, Governance and Accountability

The statutory objectives of the FSA and its strategic aims are supported through a timely and effective use of an enforcement toolkit, in a manner consistent with the Principles of Good Regulation discussed earlier. To provide such support, the FSA benefits from the Enforcement and Financial Crime Division, which investigates whether and when firms breach the rules or the provisions of the Financial Services and Markets Act. In cases where a breach is detected, the FSMA allows the FSA to take such action as withdrawing a firm's authorisation, disciplining authorised firms and people approved by the FSA to work in those firms, imposing penalties for market abuse, applying to the court for injunction and restitution orders and even prosecuting various offences.

The FSMA also grants the FSA the powers to take action under the insider dealing provisions of the Criminal Justice Act 1993 and the Money Laundering Regulations 2007. The FSMA provides the tools the FSA needs to carry out the duty of enforcement. This includes the power to interview people and require them to hand over specific pieces of information or documents. Equally relevant to its enforcement powers is the FSA's ability to investigate people who are carrying on regulated activities such as accepting deposits or giving investment advice, without authorization. As a prosecuting body, the FSA takes a serious view of such criminal offences. In fact, those breaking the law risk imprisonment and other sanctions. In conducting its enforcement activities, the FSA also works with other regulatory bodies and law enforcement agencies, such as the police.

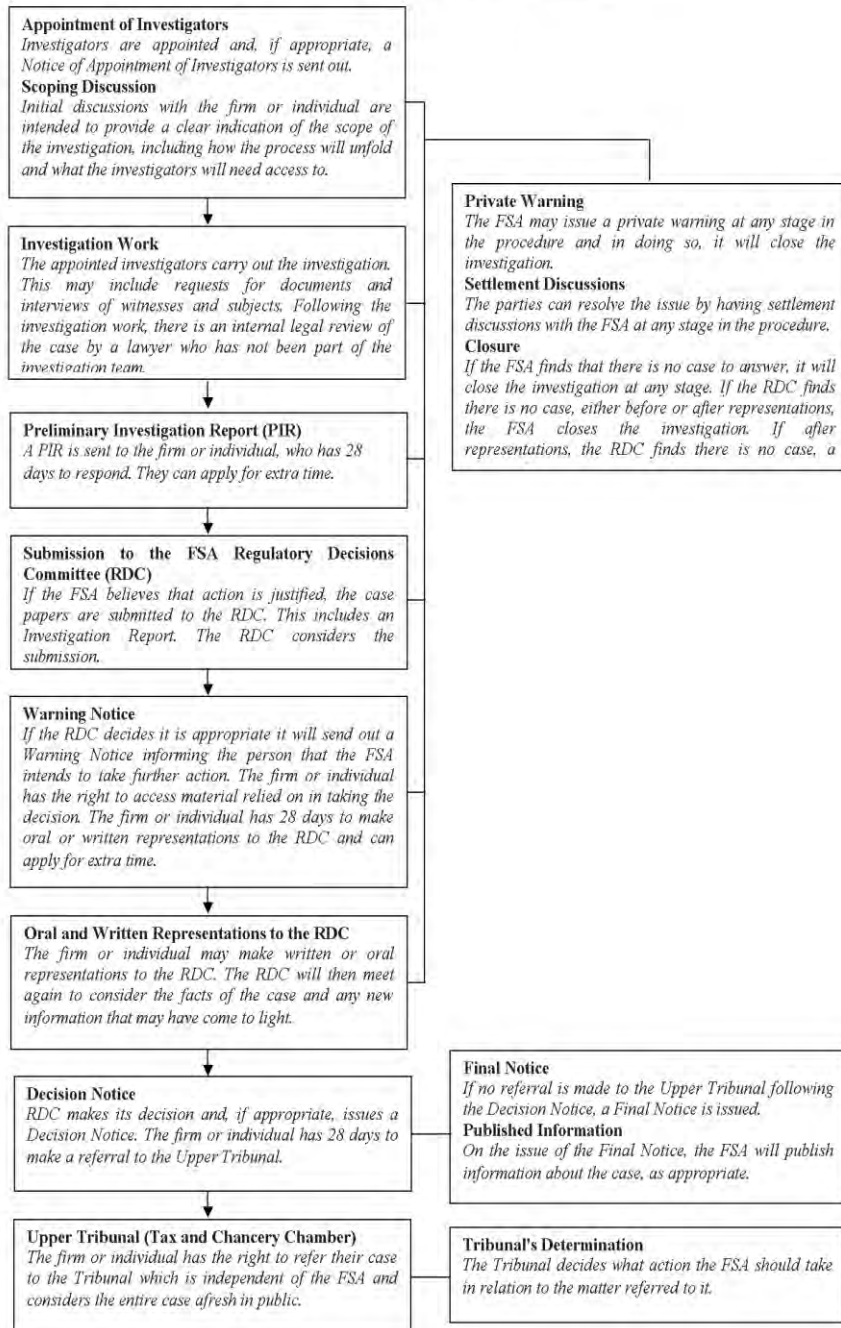
In selecting which cases to pursue, the FSA again adopts a risk-based approach which implicitly involves considering its regulatory objectives set forth in the FSMA, the principles of good regulation and the FSA's referral criteria. The FSA also strives to exercise a common standard of

fairness in the use of its powers and to act in a manner that is consistent with the Human Rights Act 1998.

When the FSA considers whether to refer a case to the Enforcement and Financial Crime Division for investigation, a number of criteria are taken into account which include the FSA's statutory objectives, business priorities and other issues such as the response of the firm or individual to the issues being considered for referral. Not all the criteria will be relevant to every case and there may be other relevant considerations.

The flowchart presented in Figure 5 shows the process of an enforcement case where the matter is dealt with through the FSA's administrative powers under the FSMA. Although this procedure applies to many FSA enforcement cases, it is important to note that it does not cover all cases. The FSA also has powers to prosecute some offences through the Criminal Courts (e.g. insider dealing) and/or to bring proceedings in the Civil Courts (e.g. injunctions and restitution proceedings).

Figure (5) The FSA Enforcement Procedure



Referred cases are considered by a separate Committee of the FSA, called the Regulatory Decisions Committee (RDC). Settlement is possible at any stage of the enforcement process. For those cases that do not lead to a settlement, however, the RDC remains the decision-maker for enforcement matters. RDC members come from a wide range of backgrounds reflecting the interests of industry and consumers.

Settlement in the regulatory context is not the same as settlement of a commercial dispute. An FSA settlement is a regulatory decision taken by the FSA, the terms of which are accepted by the firm or individual concerned. Therefore, the FSA must have careful regard to its statutory objectives when agreeing the terms of a settlement.

Turning now to issues relating to the governance, accountability and complaint procedures of the FSA, the FSMA is again the main source of reference. The legal status of the FSA is that of a private entity. In conferring regulatory powers, the FSMA clearly departs from the practice adopted in the UK for the regulation of most industrial sectors (Taylor, 2001). It does not operate on behalf of the Crown and its employees are not Crown servants.¹ Nonetheless, its Chairman and the other members of the Board are appointed and, if necessary, dismissed by the Treasury. The Board is entrusted with performing the FSA's regulatory functions.

The FSA Board currently consists of a Chairman, a Chief Executive Officer, three Managing Directors and nine non-executive directors. The non-executive members of the Board make up a committee charged with the oversight of the operation of the FSA and its internal audit system. The committee also determines the remuneration of the Chairman and the executive members of the Board. Apart from the legislative powers, all the FSA's other powers can be delegated by the Board to committees, sub-committees and officials. The British Parliament has sought to strike

1- By contrast, the Bank of England is a public-law institution, even though its employees are not considered to be public employees.

a balance between the independence and the accountability of the FSA; the model adopted is similar to that of the Bank of England, although the FSA is not a public corporation. According to English law, public or private are not directly accountable to Parliament. Both the FSA and the Bank of England are primarily accountable to the Treasury, which has four main instruments for giving effect to the accountability of the FSA. These instruments offer the Treasury the powers to control the regulatory and supervisory activities carried out by the FSA and include the following:

(a) The Treasury appoints and dismisses the members of the Board, including the Chairman. Unlike the Governor of the Bank of England, the appointment of the Chairman of the FSA is not for a fixed term, nor does the Chairman have to satisfy any particular requirements. The term of office is nonetheless specified in the Chairman's employment contract.

(b) At least three times a year, the Treasury receives a report from the FSA on its activity, the achievement of its statutory objectives and its compliance with the principles of good regulation outlined in the FSMA. The report is accompanied by a report of the non-executive members of the Board.

(c) Where necessary, the Treasury may commission a review of the economy, efficiency and effectiveness of the FSA's discharge from its functions. The conduct of such reviews is entrusted to a person independent of the FSA. The subsequent report is submitted to Parliament and published in the manner considered appropriate by the Treasury.

(d) The Treasury arranges independent inquiries in cases that pose a grave risk to the financial system, or caused or risked causing significant damage to the interests of consumers, or caused or could have caused significant damage to holders of listed securities, in the event of a serious failure of the regulatory system. The results of such inquiries do not have

to be submitted to Parliament. With this provision the FSMA formalises a procedure that had already been adopted without a legislative basis (as in the BCCI case).

The FSA's accountability is not limited to the Treasury. It is also accountable to the public, certain stakeholders and, indirectly, to Parliament itself. In the first respect, the FSA must hold an annual meeting, similar to that of a public limited company, which any interested party may attend. In addition, the Treasury Select Committee of the House of Commons frequently questions senior representatives of the FSA. With regards to other stakeholders, the FSMA gave legislative recognition on a consultative basis to two pre-existing Panels: the Consumer Panel and the Practitioner Panel; the opinions of the Panels must be considered, but they are not binding. However, the FSA must explain in writing why it disagrees with a representation of a Panel. The members of the two Panels are appointed by the FSA.

The FSA is not accountable to Parliament except indirectly, in the terms described above. Nor is the FSA subject to scrutiny by the National Audit Office, since its resources come from the financial industry it supervises and not from the public purse. Lastly, from the standpoint of institutional accountability, it is necessary to consider the relationship between the FSA and the judicial authorities. The FSA is subject to scrutiny by the judicial authorities. The FSMA provides for a complaints procedure against the FSA's decisions other than those of a legislative nature: an investigator, appointed by the FSA but approved by the Treasury, acts independently from the FSA and may recommend but not require it to make compensatory payments or to remedy the matter complained of when complaints are found to have been justified (so-called *ex gratia* payments). There has been strong criticism of the role of the investigator, asking how he can act independently if he is appointed by the FSA (Alcock, 2000). Persons who consider themselves damaged by a decision of the FSA can always apply to the judicial authorities and the FSMA provides for cases to be heard by a special court, the Financial

Services and Markets Tribunal, whose decisions can be appealed to the Court of Appeal and ultimately to the House of Lords.

6. Rise of a Financial Crisis and the Future of the FSA

In August 2007, a serious credit, liquidity and confidence crisis occurred in the Credit Risk Transfer markets and gradually spread, at the global level, into the inter-bank market. As Diamond and Rajan (2009) argue there is some consensus on the proximate causes of the crisis: (a) the U.S. financial sector misallocated resources to real estate, financed through the issuance of exotic new financial instruments, (b) a significant portion of these instruments found their way, directly or indirectly, into commercial and investment bank balance sheets and (c) these investments were largely financed with short-term debt. While it is not possible to prevent crises, what can be done is to make them fewer and milder by adopting and implementing better regulation. Therefore, the objective is not more regulation but better regulation.

Following the emergence of the crisis in the US and the rise of its effects in the UK (namely the fall of Northern Rock), the Treasury, the FSA and the Bank of England published a consultation document reviewing the current regulatory and supervisory regime (BOE, HMT, FSA, 2008). The document set out a number of proposals and recommendations. Besides the review of the liquidity prudential guidelines and the reform of the deposit compensation arrangements, the report addressed a number of issues aimed at strengthening the financial stability and resilience of the banking sector. It suggested promoting initiatives in a number of areas, such as better risk management and stress testing practices in banks and other financial firms. Improving the accounting and valuation of complex and illiquid products in the securitisation market was also recommended. However, the document underlined that it is not necessarily optimal to rush into a regulatory action. It noted that consideration should be given to whether disclosure

is adequate when model-based valuations use short run time series and when unexpected correlations between seemingly different assets across and within portfolios emerge. Regarding the role of credit rating agencies, the consultation document noted that the authorities were already pressing credit rating agencies to make proposals to address potential conflicts of interest and to enhance the informational content of the ratings (expected loss distributions of structured products, probability ranges for their scores on the risk of default, measurements for other than credit risk, etc.). It also observed that the UK authorities intended to work with their international partners to identify whether there remains under Basel II an incentive to minimize regulatory capital by holding Special Investment Vehicles or other funding vehicles.

To reduce the likelihood of banks failing, the report suggested requiring banks to be in a position to provide additional evidence to the FSA at short notice that they are meeting threshold conditions on an ongoing and forward-looking basis. The three authorities also proposed a legislation to ensure that there is no statutory impediment to the FSA sharing information with the Bank of England and the Treasury for purposes of financial stability. Based on the document, formal oversight of the payment system was to be assigned to the Bank of England.

To resolve the crisis of a failing bank in a more orderly manner, the consultative document considered it important to introduce new arrangements, such as a special resolution regime often referred to as a *living will*. This includes several options such as an accelerated method to transfer the bank's business to a healthy bank (a bridge bank), the deployment of a restructuring officer and other procedures similar to those implemented in other countries. Finally, on the issue of the coordination between the Bank of England, the FSA and the Treasury, the three authorities reaffirmed the validity of the current framework, with some changes in the way the arrangements work in practice. In particular, a statutory basis for the Bank of England's stability role and better governance arrangements within the Bank to support the new

statutory obligations were recommended. Strengthening the Memorandum of Understanding to clarify responsibilities within it, in order to achieve more effective cooperation particularly when emergency liquidity assistance is needed, was also proposed.

The proposals reflected in the tripartite consultation document were developed further in the issue of the Turner Review (Review) by the FSA in 2009 which concluded there were unanswered questions on whether systemically important firms should be subject to tougher prudential requirements in relation to capital and liquidity. The Review identified arguments both for and against this matter and concluded that the case for differentiation was not yet clear. It also raised the question of whether or not anything other than Tier 1 capital was relevant for systemically important banks. The Review suggested that the difficulties of cross-border crisis management argued for a response which involved more global and local approaches. The global dimension being an intensification of the role of cross-border supervisory colleges and increased intensity of cross-border contingency planning; the national dimension being more focus on the capital and liquidity held in standalone national subsidiaries of global groups. The Review also discussed the issue of whether commercial banking activities should be kept legally separate from proprietary trading activities. It considered measures to ensure that large commercial banks do not exploit the benefits of retail deposit insurance, lender of the last resort access and too-big-to-fail status, to support excessive risk-taking. However, it was tentatively concluded that it was unlikely to be practical to achieve this through a complete institutional separation of commercial banking from all trading activities.

After the Turner Review was issued in March 2009, a series of intense debates about these issues began both in the UK and globally. For instance, in July 2009, in its White Paper the Treasury concluded that the best strategy for dealing with systemically important firms was a

combination of stronger market discipline; higher levels of capital; stronger resolution arrangements; and strengthened market infrastructure to reduce the probability of failure. Similarly, the US Treasury, in a paper published in September 2009, stated that systemically important firms (Tier 1 financial holding companies) should be subject to higher capital requirements than other firms to force them to internalise the costs of potential spill over effects. The G20 also called for stronger regulation and oversight of systemically important firms.ⁱ At the international level, the Financial Stability Board (FSB)¹ identified the issue of a global capital surcharge for systemically important firms as a crucial one, requiring rapid resolution, and the Basel Committee established a working group to make recommendations on this and other related measures. The FSB also endorsed the idea that systemically important cross-border firms should develop resolution plans (living wills). In the UK, though not to any significant extent in most other countries or at global level, there continued to be an active public debate about whether a formal separation of narrow banking from some or all investment banking is possible and desirable.

The FSA contributed extensively to the debates and its own thinking evolved in the process. In particular, the FSA announced its view that a differentiated approach to the capital adequacy and liquidity of systemically important banks is appropriate and that the development of recovery and resolution plans for systemically important firms could play a useful role in driving legal simplification and increasing the range of resolution options potentially available in future crises.ⁱⁱ

After deliberations on the consultation document and examination of responses and feedback on the Turner Review, in March 2010 the Treasury sponsored the Financial Services Act 2010 (FS Act). The FS

1-The Financial Stability Board (FSB) has been established to coordinate at the international level the work of national financial authorities and international standard supervisory and other financial sector policies. For more information setting bodies and to develop and promote the implementation of effective regulatory, on the FSB, see: <http://www.financialstabilityboard.org/>

Act, regarded by many as a legislative response to the causes of the global financial crisis, delivers significant reforms that seek to improve the quality financial regulation. The FS Act mainly amends the Financial Services and Markets Act 2000 based on which, the FSA is given new objectives and duties and its powers are extended variously. Under the considerable time pressure induced by the calling of the UK general election for 6 May 2010, the then UK Government led by the Labour Party dropped the most politically contentious provisions of the Financial Services Bill to get it passed speedily. The most important changes resulting from the FS Act are the introduction of a new statutory objective for the FSA, new powers for the FSA to obtain required information from financial firms, extensions to the FSA's enforcement powers, the FSA's power to prohibit short selling, requirement for all regulated firms to prepare and maintain living wills and to prepare, approve and disclose remuneration policies, and further policies for consumer protection. These are now explained in further detail.

As noted earlier in the paper, under FSMA, the FSA has four statutory objectives which act as guiding principles for FSA when determining how it should exercise its statutory powers and frame the scope of many of its powers. The FS Act provides the FSA with an explicit new financial stability objective with immediate effect. In considering this objective, the FSA must have regard to the economic and financial consequences of instability and the possible impact on UK financial stability of events and circumstances outside UK. Also, FSA's rule-making, permission and intervention powers are made exercisable for the purpose of meeting any of the FSA's regulatory objectives, not just the consumer protection objective.

The FS Act further grants extensive powers to the FSA to require information when and where it considers such documents and information are, or might be, relevant to the stability of one or more aspects of the UK financial system. The FSA is explicitly empowered to

require information and documents from investment funds whose assets consist of or include financial instruments which are traded in the UK or were issued by a body incorporated in the UK, their managers and investors.

The FS Act also extends the FSA's enforcement powers in accordance with its stated intention of building a reputation as a robust enforcer. Under the FS Act, the FSA will be able to: (a) suspend the permission of an authorised firm to carry on regulated activities where it considers it has contravened a regulatory requirement, (b) impose a financial penalty and cancel a firm's authorization where it is in breach of a regulatory requirement, (c) impose financial penalties for performance of controlled functions without approval and (d) suspend or impose restrictions on an approved person who is guilty of misconduct.

The FS Act empowers the FSA to prohibit or require disclosure of short selling, including an express authority to make rules to ban short selling in financial instruments for specified periods without prior consultation. These rules would apply to all persons whether authorised by FSA or not and may apply to short selling by persons outside the UK, but only in relation to financial investments admitted to trading on UK markets. In formulating the rules, the FSA must take account of any international agreement on short selling. The penalty for contravention is an unlimited fine or public censure.

The FS Act with immediate effect imposes a duty on the FSA to require authorised firms to prepare and maintain Recovery and Resolution Plans (RRPs), so-called *living wills*, and gives the FSA formal enforcement powers relating to the collection of information relating to RRPs. The purpose of these RRPs is to enable third parties to carry on an authorised person's business in the event of the likely or actual failure of that authorised person's business. The FSA is given discretion over which authorised firms are required to introduce RRPs, allowing them initially to focus on the largest, most complex and systemically significant firms.

The Treasury is empowered to make regulations which require authorised firms to prepare, approve and disclose remuneration reports covering their executives, officers, employees and consultants. The FSA is now obliged to make rules requiring authorised persons or a specific class thereof to have and comply with a remuneration policy which is consistent with effective risk management. If the FSA believes a remuneration policy is not compliant, it may take steps to deal with the failure, which can include requiring the policy to be revised, and the FSA may specify that certain remuneration agreements in breach of its remuneration rules are void. These new provisions provide clearer legislative backing for the FSA's Remuneration Code which came into force on January 1, 2010.

With immediate effect, the FSA is required to establish a new consumer financial education body to educate the public on financial matters and the management of their own financial affairs; the FSA's objective of promoting public understanding of the financial system will be removed from a date to be decided. The FS Act also contains provisions which enable the FSA to require firms to operate consumer redress schemes where consumers have suffered loss in cases involving large scale consumer miss-selling or other failures and, in the consumer credit arena, introduce restrictions on the issuing of unsolicited credit card cheques to individuals.

The UK Treasury, in a document entitled *A new approach to financial regulation: judgement, focus and stability* (http://www.hm-treasury.gov.uk/d/consult_financial_regulation_condoc.pdf) presented to the parliament acknowledged that the UK's tripartite regulatory system had failed in a number of important ways. For example, it failed:

- to identify the problems that were building up in the financial system;
- to take steps to mitigate them before they led to significant instability in financial markets; and

- to deal adequately with the crisis when it did break, especially during the first part of the crisis in the summer of 2007.

The document goes on to add that under Lord Turner and Hector Sants, the FSA's chief executive, the FSA has made significant progress in identifying and fixing these problems. The (UK) Government believes, however, that more fundamental reform than this will be necessary. This is why, as announced by the Chancellor in his Mansion House speech on 16 June 2010, the UK Government is now embarking on a programme of reform to renew the UK's system of financial regulation, and to make it stronger and more effective for the future. Under these programmes the FSA is to be disbanded and its role for macro prudential supervision of the financial firms to be transferred to a subsidiary of the Bank of England.

This was a failure of the tripartite system as a whole, with the FSA getting a fair share of the blame. The creation of the FSA and its contribution to the advancement of the financial regulation and supervision, and the bulk of its processes are likely to survive, albeit within a subsidiary of the Bank of England.

7. Endnotes

i- In response to criticism directed at international accounting rules which may have contributed to the crisis, the International Accounting Standards Board (IASB) set up the Financial Crisis Advisory Group (FCAG) to provide advice to both the IASB and the US Financial Accounting Standards Board (FASB) on how improvements in financial reporting could contribute to improved investor confidence in financial markets. The FCAG also works to identify significant accounting issues that require urgent and immediate attention. Areas where the FCAG is currently focused include: financial reporting standards that could have provided more transparency to help either anticipate the crisis or respond to the crisis more quickly; whether existing priorities should be reconsidered in light of the crisis; potential areas that require the

attention of the IASB and the FASB in order to avoid future market disruption; the implications of the credit crisis for the interaction between general-purpose financial reporting requirements for capital markets and regulatory reporting, particularly for financial institutions; the relationship between fair value and off-balance sheet accounting and the current crisis, both during and leading up to the crisis; the need for a due process for accounting standard-setters and its implications for resolving emergency issues on a timely and inclusive basis, and; the independence of accounting standard-setters and governmental actions to the global financial crisis. (See: [http://www.iasb.org/Financial+ crisis/Response+to+the+credit+crisis.htm](http://www.iasb.org/Financial+crisis/Response+to+the+credit+crisis.htm)).

A report reflecting the views of the FCAG on the crisis can also be found at: <http://www.iasb.org/NR/rdonlyres/2D2862CC-BEFC-4A1E-8DDC-F159B78C2AA6/0/FCAGReportJuly2009.pdf>.

The IASB also agreed to accelerate its programme to respond to issues and recommendations identified by the FSB, the G20 and others, including plans to issue a new revised financial reporting standard to replace IAS 39 with the objective of improving and simplifying accounting for financial instruments, loan loss provisioning and hedge accounting. Accordingly, in November 2009, the IASB issued IFRS 9 which replaces IAS 39 and covers the classification and measurement of financial assets. The Board is now addressing the classification and measurement of financial liabilities based on an exposure draft issued in May 2010, *Fair Value Option for Financial Liabilities*. The FSB has stressed the need for convergence of accounting standards and to take into account their pro-cyclicality effects, and has encouraged the IASB to explore ways to further enhance its technical dialogue with prudential authorities, market regulators and other stakeholders on financial institution reporting issues.

Following a request from the G20 leaders in April 2009 and given the importance of large and systemically-important financial institutions,

the International Monetary Fund (IMF), the Bank for International Settlements (BIS) and the Financial Stability Board (FSB) prepared a joint report on guidance for national authorities to assess the systemic importance of financial institutions, markets and instruments. According to the report, *systemic risk* is defined as a risk of disruption to financial services that is (a) caused by an impairment of all or parts of the financial system and (b) has the potential to have serious negative consequences for the real economy (IMF-BIS-FSB, 2009). The report emphasises three key criteria that are useful in identifying the systemic importance of markets and institutions. These are: (a) *size* measured as the volume of financial services provided by the individual component of the financial system, (b) *substitutability* defined as the extent to which other components of the system can provide the same services in the event of a failure and (c) *interconnectedness* which refers to the linkages with other components of the system and the potential for a firm to indirectly pose threats which may affect the financial system. Analyses of these criteria should be conducted in connection to other measures of financial vulnerability (e.g., leverage, liquidity risks and maturity mismatches) and the capacity of elements of the institutional framework (e.g., clearing and settlement systems and arrangements to deal with failures as they occur) to resolve any potential failures. For more information, see: http://www.financialstabilityboard.org/publications/r_091107c.pdf.

ii-Parallel to the post-crisis regulatory and supervisory reforms, the FSA in the UK and other regulatory bodies at the EU and international level have put forth proposals that are very likely to affect the global regulatory environment. For example, in 2009 and following fierce criticism of the structure of management compensation schemes and how they contributed to encouraging risk-taking behavior in banks and other financial institutions, the FSA issued a policy paper on reforming remuneration practices in financial services (see: http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf). The European

Commission has also published reports on how Member States have put into practice the Commission's two earlier Recommendations of 2009 on remuneration policies in the financial services sector and for directors of listed companies (see: http://ec.europa.eu/internal_market/company/directors_remun/index_en.htm). These reports complement: (a) proposals put forward as amendments to rules on Credit Rating Agencies (CRAs) and (b) a public consultation launched on reforming corporate governance in financial institutions. On CRAs, the Commission has had two main objectives: ensuring efficient and centralised supervision at EU level, and increased transparency on the entities requesting the ratings so that all agencies have access to the same information. On corporate governance, the Commission has emphasised a number of key issues such as how to manage risk more effectively and how to empower shareholders (see: http://ec.europa.eu/internal_market/company/modern/corporate_governance_in_financial_institutions_en.htm).

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