BANKING REGULATION IN THE UK

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Introduction

Banks have been an integral part of the UK's infrastructure since their first inception by the Lombards' in 1663 on the banks of the River Thames in London. The nature and the scope of banks and banking services have grown beyond all recognition since the early days of banking. Today banking is an important part of the economic cycle and with the current economic crisis affecting every aspect of modern living this paper aims to provide an overview of the current crisis, the regulatory reform and the new banking architecture that is provided by the new Government.

The economic crisis 2007- present: causes and culprits

The economic crisis began in 2007 and although hard to pin point the exact moment when the crisis began it can be hypothesised that the run on the high street bank Northern Rock, was certainly a catalyst for the crisis. The ripple effects felt from the United States and the burst of their mortgage bubble was also a contributing factor. However during the beginnings of the crisis regulators were fixated on pin pointing the beginnings of the crisis and as such there were many culprits to blame. (Chambers 2010(a)).

Culprits and Blame

The lists of culprits would make interesting reading and many industry experts and academics alike have tried to create a definitive list. Hector Sants outlined that, in his view, there were seven fundamental structural failures. Conversely, the Turner Review 2009, also published by the FSA, shows an analysis of five other factors which illustrate what went wrong.

The paper puts forward the main culprits which are directly related to regulation action. These are: Lack of effective Corporate Governance surrounding the role of the Non-Executive Director in the banks; A risk taking culture having been promulgated by the short termism bonuses of the city investment banker traders; The collapse of the sub-prime market in the US with the knock on effect on the UK housing market and the sharp decline in house prices and the lack of mortgages being offered in the sub-prime arena; Lacking adequate macros-prudential oversight by the regulation in terms of an oversight in financial institutions such as shadow banks and SIVs; A flawed set of prudential rules for capital and liquidity allow banks to have less than was necessary to stop many banks from failing or turning to the government for assistance; Large elements of procyclicality with the market being unable to correct itself, therefore the market cannot be relied upon to self correct its procyclical patterns; Lack of consumer education and awareness on making sound financial decisions; and Failure to stop the consumers making a run on Northern Rock which led to widespread panic and a ripple effect felt in the banking sector of lost trust and confidence of the consumer.

Economic Cycle:

Various commentators have looked at why the financial system has experienced this economic crisis. Looking at history there has always been economic cycles of boom and bust and this is no different. Apart from that this economic crisis has had far more devastating effects because of the financial systems size. John Houston, "Fears a system without failure would never exist" (Houston 27 January 2009). Risk and failure is part of the economic system just as is success. Sir Nigel Wicks (27 January 2009) believes that we can never eradicate financial disasters. In fact you cannot eradicate the economic cycle in other words the economic cycle of boom and bust is the evolutionary cycle of the financial market and the only thing that can be done is to manage the 'bust' element of the cycle in a more effect way.

Restore consumer confidence

"Confidence [in the financial market place] is badly needed". (Moulds 27 January 2009) Moulds questions whether we are learning the rights lessons from the financial crisis to restore this confidence in the system. He believes that blame must first of all be apportioned, and that the banking industry must accept some of the blame. Consumer confidence is a key part of the new reform plans issued by the Government.

Objectives of the bank regulation in the UK during and post economic crisis
The role of the FSA

The current financial regulation regime, which lays at the heart of the criticism, came into place in 2000 with the enactment of the Financial Services and Markets Act (FSMA 2000) and the subsequent creation of the Financial Services Authority (FSA). The FSA was the meant to be the UK's single regulator which would be a watchdog with teeth. The FSA was given statutory objectives by the FSMA 2000 under the guise of statutory objectives s. 3-6 FSMA 2000. In 1998 the Bank of England Act transferred bank supervision powers from the Bank itself to the FSA by means of Part 3 s21 Banking of England Act 1998. The FSA carried out its duties along side the Bank of England and the HM Treasury. This group of regulatory bodies are known as the 'tripartite authorities'.

The policy documents issued from the FSA during the economic crisis: A reactionary approach

From a detailed content analysis of the 23 documents issued by the tripartite authorities (HM Treasury, Bank of England and the FSA) we can see a philosophy that is standard in terms of dealing with any type of crisis. That being to firstly contain the crisis and then to secondly move on to view the longer terms reform mechanisms. The banking crisis is indicative of this crisis management style.

The tripartite authorities have moved through each stage of the regulatory approach movement since 2007. To act and pass legislation when the crisis is still ever present and whilst regulatory have not settled into a cohesive and united approach is problematic and will lead to ineffective regulation. Where regulation is necessary, care needs to be taken to ensure it is largely effective, any legislation passed is reactionary and proactive to ensure confinement and protection, which is what we have seen with the banking Act 2009.

General principles of bank regulation in the UK post economic crisis

The overall theme of general principles is essential to identify because it tells the reader so much about the political and economic thinking of the legislators during the crisis. Many policy documents and legislative procedures have been put in place during this time. Each of the main Reviews and pieces of legislation will be considered in turn.

The Turner Review

The Turner Review (Review) was published on the 18 March 2009. It contains 28 recommendations within 13 areas. The Review should be read alongside the Discussion Paper 09/2 published by the FSA also on the same day. There are four Chapters contained in the Review.

Discussion Paper 09/2

The Discussion Paper (DP) underpins the Turner Review. It contains further documentation on the 28 recommendations posed within the Review. It reiterates the historical background of the crisis and the possible causes identified in the Review, which may have caused the crisis. At 219 pages long it is verbose in the extreme.

The Walker Review

In February 2009 Sir David Walker was appointed to undertake a review of corporate governance and remuneration within banks. The preliminary findings were published in July 2009 in the form of a consultation paper and responses were asked to be fed back by October 2009 with a final report in November 2009. There are five key themes to the review. These being: first, both the UK unitary board structure and the Combined Code of the FRC remain fit for purpose; secondly principal deficiencies in Bank or Other Financial Institution (BOFI) boards related much more to patterns of behaviour than to organisation. Thirdly, given that the overriding strategic objective of a BOFI is the successful management of financial risk, board-level engagement in risk oversight should be materially increased, with particular attention to the monitoring of risk and discussion leading to decisions on the entity's risk appetite and tolerance. Fourthly, there is need for better engagement between fund managers acting on behalf of their clients as beneficial owners, and the boards of investee companies. Finally, against a background of inadequate control, unduly narrow focus and serious excess in some instances, substantial enhancement is needed in board level oversight of remuneration policies, in particular in respect of variable pay, and in associated disclosures (House of Commons 12 May 2009).

To put this more simply, the main aspects of the review can be divided into three areas, governance, pay and risk.

The Banking Act 2009

Previous legislation to the Act came in the form of the Banking Act 1979 and 1987 and were enacted as a direct consequence of banking crisis. The Banking Act 1987 was repealed by the Financial Services and Markets Act 2000. In 1998 s21 of the Bank of England Act 1998 transferred to the FSA the Bank of England supervision which was previous held by the Banking Act 1987.

The Banking Bill was introduced into the House of Commons of the 7 October 2008 with a second reading on the 14th October 2008. The Bill had a very quick session in Parliament as it appeared that there was an obvious feeling of urgency to rush the Bill through the Houses. The Bill is 240 clauses long and it used three consultation documents as its basis. These were Financial stability and depositor protection: strengthening the framework; (TPA Cmnd 7308) Financial stability and depositor protection: further consultation and Financial stability; (TPA Cmnd 7436) and depositor protection: special resolution regime. (TPA Cmnd 7459)

The Banking Act 2009 received Royal assent on the 12th February 2009 and came into effect on 21

February. The Act strengthens the UK's statutory framework for financial stability and depositor protection.

The reforms that the Act brings in are: the special resolution regime; the bank administration procedure; the new bank insolvency procedure; inter-bank payments systems; Financial services compensation scheme; and to strengthen the role of the Bank of England. Many of the reforms have been welcomed by industry.

The Banking Act 2009 extends the powers of The Banking (Special Provisions) Act 2008, which was enacted to allow the treasury to rescue Northern Rock via nationalisation of the ailing bank. (Tomisac 2008 p. 2) The 2008 Act gave the Treasury extraordinary law making powers. The aim of the new legislations is not to prevent banks from failing but to allow them to fail in an organised manner that will not disrupt the industry or consumers as a whole. (The Banking Act Explanatory Notes)

The 2009 Act shows a change in philosophy by the Government and regulators alike. (The Economist 15 May 2008) Banks should be allowed to fail, because it is part of the cyclical nature of the economic system.

The White Paper 2009

During late 2009 Labour started to outline their plans for Reforming Financial Services within the UK. This came in the form of a White Paper (HM Treasury July 2009 Cm 7667). The White Paper takes a three-pronged approach to the reforms (Guardian 8 July 2009). That being to improve regulation of the financial system by implementing new powers; better management of banks through reforming remuneration packages to ensure a curbing of the risk taking culture and reforming the corporate governance of the banks' boards; and a better deal for consumers, ensuring they are protected adequately and fairly. The main ethos of the regulation is that it will focus on the macro-prudential regulation of the UK's financial system rather than the micro, which is what, has currently been regulated. The White Paper does not completely overhaul the present system of regulation.

Financial Services Act 2010

On the 19 November 2009 the Government introduced the Financial Services Bill (House of Commons Research Paper 27 November 2009). This Bill drew from the responses delivered from the White Paper (will need to add a reference here) and is built on the Banking (Special Provisions) Act 2008 and the Banking Act 2009. The Act, which received Royal Assent on April 8th 2010, is the third piece of legislation that seeks to contribute towards the government's financial recovery plan. (Chambers 2010(b)) The Act increases the duties and the powers of the FSA in various aspects relating to consumer awareness, protection of the consumers, recovery plans for banks and remuneration policies. This Act has granted the FSA with more power so that they can act in such a way as to monitor and control the financial market without having the chaos that ensued following the collapse of Northern Rock.[5]

The Act and the FSA: Friend or Foe?

Undoubtedly, the Act provides more powers and duties for the FSA. The questions that need to be asked are: do the FSA need more powers to help them regulate the financial markets; will the new powers and duties help economic recovery; and finally should these powers and duties have already been carried out as oblique elements of the overarching existing statutory objectives of the FSA?

Wider General Principles of Banking Regulation

On the 29th of January 2008 the Financial Services Authority (FSA) published its Financial Risk Outlook report. The report considered five main risks related to the economic position of the United Kingdom today and the aim here is to consider three of these: Market participants and consumers may lose confidence in financial institutions and in the authorities ability to safeguard the financial system; A significant minority of consumers could experience financial problems because of their high levels of borrowing; and Tighter economic conditions could increase the incidence or discovery of some types of financial crimes or lead to firms resources being diverted away from tackling financial crime.

Political position on the UK and European Economy

On the same day as the publication of the FSA Financial Risk Outlook Report, Gordon Brown "met his French German and Italian Counterparts to discuss the recent global market turmoil" (BBC News 29 January 2008). The aim of the meeting was to establish that given the turmoil in the economies worldwide, more transparency is called for and risks must be monitored better. In particular the IMF and other regulatory bodies were called on to ensure that there are more early warning systems for the global economy and that prompt and full disclosures of write offs should be made as soon as possible.

Consumer confidence

The current economic position is causing financial regulators concern. Consumers, it has been recognised, are loosing confidence in the financial institutions and authorities' ability to safeguard the

[5] For an excellent discussion of the collapse of Northern Rock see D Singh and J LaBrosse 'Northern Rock, depositors and deposit insurance coverage: some critical reflections' (2010) Journal of Business Law 2 55-84.

financial system (FSA Financial Risk Outlook 2008 at p.28). One of the FSA's statutory objectives is to ensure consumer confidence. If consumer confidence is not maintained then there are real risks that could be faced by consumers and the industry alike. The FSA have stated that; "there is a risk that, should market participants lose confidence, markets for certain retail and wholesale products could come under pressure, exacerbating already difficult circumstances for firms and consumers" (FSA Financial Risk Outlook 2008 at p.28).

Consumers facing financial difficulties

During the last fifteen years the UK's economy has been relatively stable, with relatively low levels of unemployment and high levels of economic activity (FSA Financial Risk Outlook 2008 at p.30). This has bought with it confidence in the financial sector with heavy reliance on the property market for short and long term investments. However the level of saving during this period has decreased. Consumers have relied on secured and unsecured lending contentedly but with the tightening of requirements to issues of both secured and unsecured credit, there is a fear that consumers will "find it hard to meet their credit commitments" (FSA Financial Risk Outlook 2008 at p.31). A lack of financial education will hinder those customers who may have to find alternatives or manage their finances creatively.

Increase of financial Crime

When there is low consumer confidence in consumers whom are thought to be not financially capable as discussed above, financial crime is risks that that the markets do not want to occur. A financial crime can be seen from two perspectives. Firstly when people are in an economic crisis sometimes they resort to crime, in the form of card fraud. Secondly, financial crime can also be from large institutions or a person from a large organisation within the financial sector. Each of these crimes would have a detrimental effect on consumer confidence and the financial difficulties that are already perceived risks outlined by the FSA. "Increasing financial pressure on firms, employees and consumers could increase the motivation of some to commit financial crime. At the same time, the consequences of crimes committed under the more benign conditions in previous years may be more likely to come to light when firms are faced with more difficult economic conditions" (FSA Financial Risk Outlook 2008 at p.34).

Main instruments and requirements post economic crisis in the UK

Throughout this paper we have discussed how regulation and reform has been affected by politics as well as economics. We can see the reform is an ever changing and moving feat for regulators and commentators. This is also true for outlining the new instruments and requirements post economic crisis. At the time of writing late 2010/ early 2011 ubiquitous agreements on requirements, measure, instruments and regulations have still not been clearly defined and agreed upon.

Capital requirements

As the UK is part of the European Union and as such complies with European rules, UK banks must adhere to plans which come from Europe. One such regulation which is greatly affecting the banks in the UK is Basel III. UK banks already comply with Basel I and II but these regulations came about before the financial crisis. Basel III is a direct consequence of the crisis and as such provides regulation reform reflecting the occurrences within the crisis. Basel II is in progress currently and not to to be completed until 2012.

Reserve Requirements

Within the UK there never was a requirement on banks to maintain a reserve requirement. This has not changed post economic crisis.

Corporate Governance

Of the many reasons proffered for the failure of banks, corporate governance has come under immense scrutiny at the present time. In particular, the role of the non-executive director (NEDs) has been at the cornerstone of the criticism. Corporate governance of banks is regulated by the Combined Code on Corporate Governance. The Code states that 'every company should be headed by an effective board, which is collectively responsible for the success of the company'.

In July 2009, the Walker Review, headed by Sir David Walker and sponsored by HM Treasury, reported back on the reform of corporate governance in the industry (Walker Review July 2009). What is clear is that this culprit will be expounded upon for many more months and years to come. In essence there were five main themes of the review: To assess whether the Combine Code remains fit for purpose; To assess whether the principal deficiencies of the bank executives where behavioural rather than organisational structure; To assess the nature of risk within the banking business; To assess whether there is a need for more engagement in board matters from fund managers and other major shareholders; and To review the remuneration procedures of top bank executives.

Financial Reporting and Disclosure

As seen above, banks in the UK are treated no differently to other companies and as such are compelled to comply with company regulations and laws. UK banks and other financial institutions are subject to rules under the Generally Accepted

Accounting Principles (GAAP). GAAP can be divided into two sections mandatory and advisory. Mandatory requirements can be found under: The Companies Act 2006; Financial Reporting Standards issued by the UK Accounting Standards Board; Statements of Standard Accounting Practice adopted by the UK Accounting Standards Board; UTIF Abstracts issued by the Urgent Issues Task Force of the UK Accounting Standards Board; and, Listed companies must also comply with the reporting requirements set out in the Listings Rules of the London Stock Exchange, and AIM (Alternative Investment Market) must comply with AIM rules.

Credit Rating Requirements

Credit rating agencies (CRAs) are independent institutions that provide opinions on an entity's ability to repay its debts on time. It provides ratings on entities issuing debt to enable a third party to assess investing, lending or purchasing from the debt issuer. Both the US and the UK have viewed CRAs as being a contributing factor in the credit crisis. It has been argued that because of the ratings given to sub-prime mortgages together with sharp and substantial downgrades to companies and product ratings the US housing market started to burst. Further criticism has been laid at CRAs feet given that they operate in a largely oligopolistic market, given the limited number of agencies providing such information. Secondly CRAs are paid by the debt issuer (bank, financial institution, corporate entity and sovereign issuers) to provide the rating. This could lead to a subjective and non-independent rating being provided which does not give a transparent rating for the market. Currently, credit ratings are controlled by Standard and Poor's, Fitch Ratings and Moody's, all US-based institutions.

Payment system requirements

For the first time in the UK and as of a direct consequence of the Payment Services Directive in the European Union, the Payment Services Regulation 2009 will take affect and be fully in force by 30 April 2011. However from the 1 November 2009 payment services are subject to this new single regime. The rest of the financial industry will become subject to the new regulations over a two year period. The FSA along with the Office of Fair Trading (OFT) and the Financial Ombudsman Scheme (FOS) will regulate and monitor the application of the regulation. The regulation takes many traits from the Directive.

Deposit protection schemes

The Financial Services Compensation Scheme objective is to provide protection to consumers for business undertaken in the UK with UK regulated institutions. There always was consumer protection for deposits in the UK but this has been bolstered due to the crisis and the run on Northern Rock in 2007. The protection is as follows: Deposit taking firm: the limit is 100% of the first £50,000 per individual; Insurance firm: 90% of the value of the claim without an upper limit. Compulsory insurance claims are covered in full; Investment firm: the limit is 100% of the first £50,000 per individual; and Mortgage advising or arranging: the limit is 100% of the first £50,000 per individual.

The new way forward for UK banking regulation architecture.

<u>The FSA versus the Bank of England as the UK's primary regulator</u>

It has not just been the electorate which has been held in turmoil over the last year in the UK but also the fate of the Financial Services Authority (FSA) and the Bank of England regarding their future role in financial regulation. Now that the United Kingdom (UK) has a coalition government between the Conservatives and the Liberal Democrats, the fate of both of these power houses in banking regulation are a little clearer. Or are they?

The compromise of the election

<u>Banking Reform</u>

The plan outlines many issues these being: To introduce a banking levy. To tackle excess remuneration for bankers which promulgate excessive risk taking within the market and thus reducing risk. To create a competitive and balance banking industry with more diversity and help for promoting mutals; To support the flow of credit for SME's; including major loan guarantee scheme, the use of net lending targets for the nationalised banks; To reduce systematic risk; To establish an independent commission to investigate separating retail and investment banking; To bring forward the proposals to give the Bank of England control over Macro-prudential regulation and oversight of micro-prudential regulation; and to finally, to rule out joining the Euro during the term of the agreement. (BBC News 12 May 2010).

The FSA's uncertain future

The FSA therefore appears at first glance to have gained a reprieve from being dismantled and engulfed by the Bank of England, however, reform is coming and the role of the Bank of England, from the above, can be noted as to be gaining in strength. The future of the FSA has therefore been rocked, whether more power is given to them but under the careful supervision of the Bank of England or whether they are phased gradually, only time will tell. Like with the final result of the election, the fate of the FSA will be clear in time.

New legislation and the new architecture Small and simplistic banks

What has been expounded is the notion that banks should return to a simplistic form of banking (BBC

News 22 February 2009). The simplistic banking would entail a move from the highly sophisticated and complex financial products to a more simplistic form of banking (BBC News 22 February 2009). There has also been a suggestion to separate the two forms of banking, investment and retail. (HM Treasury 1 May 2009)

Cyclical nature of regulation

Financial regulation and economic development have one thing in common – they both develop in a cyclical manner and intertwine. This is especially the case following the recent announcement by the coalition government to emancipate the Financial Services Authority (FSA), which was heralded as being the 'darling' of the regulatory world. During this time span, the United Kingdom (UK) has seen a 'golden age' of finance which has resulted in a housing boom and an unprecedented period of economic prosperity. At the heart of this part of the paper is the proposition that everything in finance, whether it is the economic boom and bust, or the regulatory structure is set to this metronome of cyclicality.

The Current Reforms

On the 16 January 2010 Chancellor George Osborne made his maiden speech at the Mansion House in London. The main reforms outlined by the Chancellor are addressed in the next part of the paper, namely the independent body responsible for the setting of the budget; to transfer power from the FSA to the Bank of England and plans to dismantle the FSA entirely.

Office of Budget Responsibility

George Osborne stated that he is concerned that the UK will face a sovereign debt crisis if it does not tackle the private debt problem and the budget deficit. Osborne opined that; "the power the Chancellor has enjoyed for decades to determine the growth and fiscal forecasts now resides with an independent body immune to the temptations of the political cycle" (HM Treasury 16 June 2010). This is an enormous and monumental change. Indeed "budget making in Britain has been changed forever" (HM Treasury 16 June 2010).

Emancipation of the FSA and the Rise of the Central Bank (again!)

Another area of uncertainty is the new framework for financial supervision in Europe, something which is likely to be finalised within the coming weeks and adds yet another level to the uncertainty at the present time of the currently regulation regime. It is here, at this conjecture that Osborne moved onto his most radical reform proposals. The new reforms are a "new system of regulation that learns the lessons of the greatest banking crisis in our lifetimes, the government will abolish the tripartite regime and the FSA will case to exist in its current form" (HM Treasury 16 June 2010).

Structural Changes: To split or not to split, that is the question

The third area of reform is to the structure of the banks within the market place. There has been clear discussion as to whether there is a need to split bank functions into two sole purpose institutions – retail and Investment. A move which would mirror the United States repealed Glass-Stegall Act 1933. The lack of competition and the concentration of banks within the UK markets as well as the ethical implication of pay and bonuses have influenced this debate.

The Future is clear, the future is ... or is it?

Over the next year more details will emerge from the government as to how this transition period will work. It is also clear as to the role of the Bank of England (primary regulatory) and the FSA (continue until 2012 (Inman 16 June 2010). However the mechanics of enabling this to occur is unclear. For example, what is going to happen to the FSA's statutory objectives? Will they still remain? If they do how will this statutory power be transferred?

Conclusions

Banking crisis' are difficult to predict and difficult to chart their progress and end. Recovery is always a slow process and not often truly recognised until it is well under way. The UK like many other countries in the world has been greatly affected by the current economic crisis of 2007. Some four years later its repercussions are being felt and it is predicted will continue to be felt for many years. Whether economic progress is started is a nebulous matter and certainly alters from day to day. Small economic changes greatly affect such a fragile economy. This paper has looked back over the last four years and has examined the crisis, and its many culprits of blame. The author has discussed these culprits at length due to the regulation and policy decisions taken around them to change the way in which the financial sector in the UK is regulated.

What can be deduced from the crisis is that banking history can teach us many things, economic evolution means that crisis must happen for the market to move on and change. However, this present crisis has also indicated that the truly complex and inter-mingled financial market place which created enormous wealth can also create enormous hardship on nation's world wide. Caution and simplistic banking can only be the way forward if economic prosperity is to be seen again. Regulations must be robust and clear but cannot constrict the market place from innovation. Risk must be cautioned against evolution yet allowed to thrive in controlled environments. Capitalism therefore must be allowed to be re-born from the embers of the crisis and a new financial world and regulations must emerge.

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