

The UK Financial Services Authority: Unified Regulation in the new Market Environment

by

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INTRODUCTION

Several recent developments - notably, the break-down of traditional distinctions between different types of financial activity, the globalisation of financial markets, and increasing emphasis on systemic stability as a regulatory objective - have prompted policy-makers to search for an 'optimum' regulatory structure that is adapted to the new market environment. The UK has undertaken the most radical overhaul of its regulatory arrangements by locating regulatory responsibility for the entire UK financial services industry within a single all-embracing regulatory agency - the Financial Services Authority (FSA). With some countries, notably Japan, moving in the same direction and others (e.g. Germany, Ireland and Austria) planning to do so, attention is increasingly focused on the merits of the UK approach.

This paper examines the case for a single financial regulator in the context of the UK's recent regulatory restructuring. The first section reviews the objectives, targets and techniques of regulation within a segmented financial services industry; the second section describes the new market environment; the third section analyses the implications for the structure of regulation; the fourth section describes and assesses the new UK regulatory regime; and the final section provides a summary and conclusion.

SECTION 1: OBJECTIVES, TARGETS AND TECHNIQUES OF REGULATION

This section describes the objectives, targets and techniques of regulation within a segmented financial services industry characterised by specialist financial institutions conducting distinct financial activities (banking, securities business, insurance etc.).

1.1 Objectives of Regulation

The case for regulating financial institutions can be made on three broad grounds. First, there is the consumer protection argument. This is based on the view that depositors and investors cannot be expected to assess the riskiness of financial institutions they place their money with, nor to monitor effectively the standard of service provided by such institutions. The consumer protection rationale gives rise to three categories of regulation: first, compensation schemes designed to reimburse all or part of losses suffered through the insolvency of financial institutions; secondly, regulation in the form of capital adequacy requirements and

other rules aimed at preventing insolvency; and finally, conduct of business or market practice rules intended to ensure that users of financial services are treated fairly. Both the second and third type of regulation reflect market imperfections arising from, inter alia, asymmetric information, principal-agent problems, and the fact that the value of a financial product or service may only be determinable well after the point in time at which it is purchased.

The consumer protection rationale for regulation is closely related to another concern. If depositors or investors are to be reimbursed for losses incurred through the insolvency of financial institutions then there will be little or no incentive to exercise care in the choice of depository or investment institution. This in turn means that risky institutions will be able to attract business with the same ease and on the same terms as more prudently run firms, thereby undermining financial market discipline and increasing the incidence of insolvencies. The ensuing losses must then be borne by the deposit insurance scheme, investor protection fund, or ultimately, the taxpayer. Prudential constraints on financial institutions' risk-taking then become necessary in order to limit such losses and to offset the regulatory incentives in favour of excessive risk-taking.

A third objective of financial regulation is to ensure the integrity of markets, embracing such diverse matters as money-laundering, market manipulation, price discovery, fairness (for instance, in terms of access to information) and, above all, transparency. Market integrity focuses on the organisation of the market as a whole rather than on the bilateral relationships between financial institutions and their customers (i.e. conduct of business).

Among many supervisors the rationale for financial regulation that gives most cause for concern is systemic risk - that is, the risk that the failure of one or more troubled financial institutions could trigger a contagious collapse of otherwise healthy firms. It is, above all, their alleged susceptibility to contagious disturbances that distinguishes financial institutions from non-financial firms. The scale of the systemic risk problem is underlined by recent research showing that in 24 post-1980 banking crises, covering both developed and developing countries, the fiscal costs alone amounted on average to 16% of GDP.¹

¹ Hoggarth et al. (2001), p.15.

These, then, are the main considerations behind the regulation of financial institutions: consumer protection, moral hazard (a consequence of consumer protection), market integrity and systemic risk. In addition it should be noted that a further major regulatory objective is to achieve competitive equality - between financial institutions from different countries, between functionally distinct financial firms (banks, securities firms and insurance companies) that carry on the same kinds of business, and between rival financial centres. Concerns about competitive equality do not provide an independent justification for financial regulation but they do often provide an important impetus to international regulatory co-ordination initiatives. For instance, the European financial market directives have been framed with the explicit objective of achieving a 'level playing field', and the original motivation behind the Basel Accord on minimum capital standards was the perceived need to avoid competitive distortions associated with uneven national capital requirements.

1.2 Targets of Regulation

Within a segmented financial market regime characterised by specialised financial institutions, the main targets of financial regulation are banks, investment firms, insurance companies, fund management companies and exchanges (incorporating clearing and settlement arrangements). The various rationales for financial regulation described above apply in different ways to these separate segments of the financial services industry, as described below.

Banks are characterised by short-term and unsecured value-certain liabilities (deposits) and illiquid value-uncertain assets (commercial loans). Banks are subject to deposit insurance and other forms of consumer protection, in part because banks' balance sheets are opaque and depositors are therefore not in a position to assess the riskiness of their deposits. Depositor protection in turn gives rise to moral hazard. But the case for bank regulation also rests heavily on systemic risk - that is, the alleged potential for destructive bank runs that can endanger not only individual institutions, but the stability of the banking system as a whole. According to this view, bank runs are caused by depositors seeking to withdraw their funds in response to the fear of bank asset losses that could lead to insolvency. Given the nature of the deposit contract (that is, a fixed nominal claim) those who run first can expect to be repaid in

full, while those who delay withdrawals risk losing some or all of their deposit balances. Therefore, depositors have a (rational) propensity to run at the first sign of trouble.

The more recent academic literature does not rely on any loss in the value of a bank's underlying assets to explain the occurrence of bank runs.² The focus instead is on a bank's transformation services - specifically the conversion of illiquid assets (bank loans) into liquid claims (bank deposits) - and the fact that a bank's loan portfolio is worth significantly less in liquidation than on a going concern basis. All that is required to make a run possible - and rational - is that the liquidation value of the loan portfolio is less than the value of the liquid deposits. This approach explains how runs can occur even in the case of healthy banks, since the victim institution will be forced to dispose of its assets at liquidation prices, thereby threatening insolvency.

Investment firms, in contrast to banks, are characterised by short-term but (generally) secured liabilities and liquid assets whose value is transparent, albeit subject to fluctuations. For investment firms the case for regulation has traditionally rested on consumer protection - the idea that investors should bear the market risk associated with their investments but should not be fully exposed to the risk of default by the intermediary through whom they transact.

On the other hand investment firm failures are much less likely to have systemic consequences than the failure of banks. The assets of a non-bank investment firm consist largely of marketable securities and there will therefore be little difference between their value on a going concern basis and in liquidation, in marked contrast to banking assets - which are worth considerably less in liquidation. This means that a troubled investment firm will generally be able to wind down its business in an orderly manner, meeting its obligations by prompt asset disposals at close to book value. On the liabilities side too, investment firms are generally less vulnerable than banks, because much of their funding is secured and in any case cannot be immediately withdrawn, as can bank sight deposits. To the extent that funding is curtailed, an investment firm will generally be able to contract its way out of trouble. In short, investment firms are much less vulnerable to contagious liquidity and solvency crises than are banks.

² See Diamond and Dybvig (1983, 1986).

Insurance companies are characterised by long-term liabilities of uncertain value and liquid value-certain assets. Among the major categories of financial institution, this balance sheet structure is least likely to give rise to systemic risk, liquidity transformation being in the reverse direction to that of banks. Regulation of insurance companies is based on consumer protection, reflecting the fact that it is difficult for consumers to assess an insurer's financial strength or the quality of its products. In addition insurers may increase their risk after policyholders have purchased a policy and paid premiums. Therefore, in the absence of regulation, imperfect consumer information and agency problems may result in a (socially) excessive level of insolvencies. For similar reasons, conduct of business regulation is also an important aspect of the regulatory framework for insurance companies.

Fund management companies invest not on their own account but on behalf of their customers. This agency role means that investors are protected from a management company's insolvency so long as funds under management are segregated from the latter's own assets. Regulation of fund management companies accordingly focuses on conduct of business (advertising, disclosure, charges, etc.). Systemic risk is not generally a consideration here.

Securities exchanges, as distinct from exchange members, are regulated to ensure market integrity. In general, exchanges have not been viewed as a potential source of systemic risk, although, in respect of securities clearing and settlement, this perception is changing (below). On the other hand, wholesale interbank payment systems, as the linch-pin of the banking system, have traditionally been subject to rigorous central bank scrutiny to minimise systemic risk.³

In summary, systemic concerns have in the past tended to focus exclusively on banks and payment systems. Consumer protection regulation, on the other hand, is applicable to all categories of financial institution. While deposit protection (and hence moral hazard) has been a particular feature of banking, all institutions providing retail financial services have been subject to conduct of business regulation. Finally, market integrity is the primary regulatory objective for securities exchanges.

³ See, generally, Dale (1997).

It may be noted that so long as the financial activities above are distinct and separate, regulation is both functional and institutional. This follows from the fact that particular functions are carried on within specialised financial entities: regulation of the function is tantamount to regulation of the associated entities and vice versa.

It is also worth noting that within the above framework issues of regulatory neutrality as between different categories of financial firm are de minimis. This is because there is relatively little business overlap between different categories of specialist financial firm.

1.3 Techniques of Regulation

While techniques of conduct of business regulation do not vary significantly across different categories of institution, when it comes to prudential regulation there are important differences that reflect the different risk characteristics of banks, investment firms and insurance companies.

Because bank failures can have systemic consequences, there is traditionally a strong emphasis on protective bank regulation in the form of lender of last resort facilities and deposit protection (which in turn gives rise to moral hazard). In this context the extent of deposit protection may be well in excess of the protection offered by deposit insurance schemes, reflecting policy-makers' preference for safeguarding banking institutions and not merely depositors. Also reflecting the regulatory goal of sustaining banks as going concerns, preventive regulation, aimed at curbing excessive risk-taking, has tended to focus on capital adequacy requirements with assets, for this purpose, valued on a going concern basis.

In contrast to the above, investment firms are regulated with a view to ensuring that they can wind down their business rapidly when they run into trouble. Accordingly, investment firms' assets are required to be liquid and marked to market. In addition, regulators typically require that customer assets be segregated from those of the firm. These key instruments of regulation - asset contraction and insulation of customers - sharply differentiate the traditional regulatory approach of securities and bank regulators.

Insurance companies are different again. Prudential regulation here focuses on long-term solvency based on actuarial principles, taking account of the uncertain value of long-term liabilities. In other words, solvency requirements have to address not only asset risk but also liability/underwriting risk.

Fund management companies are not subject to extensive prudential regulation while exchanges are typically self-regulated on the basis of membership capital requirements.

1.4 Assessment

In the traditional financial framework described above the financial services industry is divided into separate pillars (banks, investment firms, insurance companies, etc.), each with its own distinct regulatory regime, reflecting differing regulatory objectives and techniques (see Table 1). Regulation is both functional and institutional since institutions are co-extensive with particular activities. At the same time regulatory neutrality is not a major issue because the separate pillars within the industry do not compete directly with one another. This may be viewed as a dream world for regulators in which regulatory objectives, targets and techniques are neatly compartmentalised and problems of regulatory interface do not arise. However, in the new financial market environment described in the following section issues of regulatory structure and co-ordination become much more problematic.

TABLE 1. TARGETS OF REGULATION			
	ASSETS	LIABILITIES	REGULATORY OBJECTIVE
BANKS	Illiquid, value uncertain (book values)	short-term, value certain, unsecured (deposits)	moral hazard, depositor protection, systemic risk
INVESTMENT FIRMS	Liquid, mark-to-market	short-term, secured	investor protection
INSURANCE COMPANIES	Liquid, value certain	long-term, uncertain values	consumer protection

FUND MANAGEMENT COMPANIES	agency role	investor protection
EXCHANGES	counterparty risk	market integrity
PAYMENT SYSTEMS	counterparty risk	systemic risk

SECTION 2: THE NEW MARKET ENVIRONMENT

The compartmentalised model of the financial services industry and its regulatory framework has over the past decade or so been transformed by market developments. The traditional pillars of banking, securities business, insurance and fund management are being displaced by a quite different industry structure in which hitherto discrete activities are conducted within the same financial services group.⁴ The Group of Ten's recent report on consolidation in the financial sector concluded that this trend was likely to continue and that "the consolidation of an increasingly wide range of financial activities within large and complex organisations that include banking units points to an increased risk of contagion effects running from the non-bank to the commercial bank parts of the same organisation."⁵

2.1 Functional Integration

The process of functional integration reflects the perceived efficiency benefits of combining financial services under one corporate roof. Such benefits are of two kinds: firms may realize internal economies of scope through joint production and marketing of diversified financial services; and users of financial services may realize external economies of scope because they can more conveniently purchase several financial services at a single location or from a single firm.⁶

There are various degrees of functional integration which may be associated with different levels of efficiency gains. The first stage of integration is based on ownership linkages

⁴ See OECD, 1997a,b.

⁵ Group of Ten (2001), p.16.

⁶ See Litan (1987), pp.60-98.

between financial firms conducting different types of business. The second stage of integration involves exploitation of economies of scope through, for instance, cross-selling of financial services. Such efficiency gains may be significant where banks' branch networks are used to sell fund management, insurance and securities products, possibly under a single brand name. A third, and crucial stage, of integration occurs when financial conglomerates adopt a centralised approach to risk management. The rationale for such a policy is based, firstly, on potential economies of scale and scope related to advanced computer technology and highly specialised skills in quantitative risk measurement, and secondly on the ability to unbundle discrete categories of risk within different parts of an organization and then to monitor and manage those exposures on a consolidated basis for the group as a whole.

2.2 Deregulation and erosion of boundaries

For the purposes of the present discussion the key development is the integration of hitherto discrete segments of the financial services industry through a combination of ownership linkages and centralised risk management. However, there are other important considerations.

First, the commercial impetus towards financial conglomeration has coincided with a change of regulatory philosophy. The new thinking rejects activity constraints on banks and other financial firms as being inefficient and heavy-handed, and instead focuses on capital adequacy requirements to cover the risks associated with whatever financial activities a group chooses to undertake. The recent dismantling of Japan's statutory separation of banks, securities firms and trust banks, and the 1999 US legislation removing Glass-Steagall restrictions on banks' securities activities are examples of the new regulatory approach.

Second, quite apart from ownership linkages between different categories of financial firm, the distinctiveness of the business of banking and other financial activities is gradually being eroded. For instance, on the liabilities side of the balance sheet, internationally active banks have been increasing their secured funding - a form of financing traditionally associated with investment firms.⁷ On the assets side of the balance sheet there is also convergence, with the proportion of loans to non-banks in total bank assets (a measure of banks' illiquid assets) tending to decline. For instance, the Bank of England has calculated that for large UK,

⁷ See George (1997), p.8.

internationally active, banks the share of such loans fell from 65-70% to 50% or less during the 1990s, a decline attributable to the expansion of these institutions' investment banking operations.⁸ Furthermore, there is a trend towards increased secondary market trading of bank loans, thereby blurring the traditional distinction between bank loans and securities. It may also be difficult to categorise particular transactions as banking, securities or insurance products: for instance, it has been claimed that J P Morgan Chase in effect made loans to Enron that were structured as energy trading contracts so that they could be held off the balance sheet.⁹

Finally, the growth of new complex instruments and credit derivatives has facilitated risk transfers between different categories of financial institution - notably banks and insurance companies. This development reflects the fact that while banks may have a comparative advantage in arranging loans they may have no such advantage in bearing and managing the associated risks. For instance, banks have been transferring risk, on both a funded and unfunded basis, to the insurance sector through the issuance of asset-backed securities, asset-backed commercial paper and collateralised debt obligations as well as through credit default swaps. The result is that credit risk is being shifted within and between financial groups in complex ways that specialist functional regulators may find difficult to identify and monitor.¹⁰

2.3 Consolidated Supervision

The above developments, involving financial conglomeration, centralised risk management and the blurring of traditional distinctions between banking and other types of financial activity, have prompted regulators to adapt their approach to supervision.

Consolidated supervision is one key ingredient of the new regulatory approach. Under this regime the various entities within a financial conglomerate are supervised on a group-wide basis and capital requirements, actual capital and risk exposures are subject to group-wide supervisory assessment. The Joint Forum on Financial Conglomerates, representing bank,

8 See George (1997), p.10.

9 "SEC investigates credit risk of US bank 'loans'", Financial Times, January 16, 2002.

10 See Rule (2001).

insurance and securities supervisors, has described consolidated capital adequacy assessment as follows:

“..... subsidiaries are usually consolidated in full For prudential purposes, regulatory capital in excess of such a subsidiary’s own regulatory capital requirements, and which can be regarded as in principle available to support risks in the parent company or other entities in the group should a shortfall arise, can be recognised in a group-wide capital adequacy assessment”¹¹

In other words, under a consolidated supervision regime, both risk exposures and capital available to back those exposures are viewed as accruing to the group as a whole. Risks are no longer to be assessed on a legal entity basis or on the basis of the category of financial activity being undertaken. This holistic approach is consistent with the trend towards centralised risk management within financial conglomerates noted above and brings regulatory risk appraisal into line with financial firms’ own risk management practices.

2.4 Assessment

In recent years there has been a progressive erosion of the traditional demarcation lines that have separated banking from other, non-bank financial activities. This development reflects cross-functional ownership linkages between different categories of financial firm, the blurring of distinctions between banking and non-banking business through ‘securitisation’ and other forms of financial innovation, and the dismantling of legal activity constraints previously applied to banking organisations. At the same time large diversified financial groups have tended to adopt a centralised approach to risk management that ignores traditional boundaries between different financial activities.

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See BIS (1998) Joint Forum on Financial Conglomerates. p.11, para. 32.

In the new financial environment it is no longer possible to identify separate sets of regulatory objectives, targets and techniques covering banking, securities business, insurance, and fund management. Banks are no longer ‘special’ in the sense of being uniquely exposed to systemic risk because their activities and risk exposures have become intermingled with non-bank financial business. The regulatory objective of systemic stability now extends to investments firms,¹² securities and derivatives clearing and settlement systems and even insurance¹³ and fund management entities (dramatically underlined by the recent debacle over Long-Term Capital Management). The need to curb moral hazard through regulatory action similarly embraces all those activities undertaken within a conglomerate that may benefit, directly or indirectly, from the availability of lender of last resort support.

The targets of regulation are no longer distinct because corporate entities and groupings are no longer co-extensive with identifiable lines of business. At the same time, the consolidated supervision of financial conglomerates, as described above, explicitly recognises the interdependence of risks and capital resources within diversified financial groups. Furthermore, the techniques of regulation are no longer business-specific. Reflecting recent developments in financial technology and risk measurement, regulators are moving away from static, point-in-time balance sheet analysis and focusing instead on the process of risk management. This entails an assessment both of management’s risk models and internal control procedures. Since the new approach to regulatory risk assessment applies across different categories of financial activity - banking, securities business and insurance - there is no longer a clear justification for separate regulation of these activities on grounds of regulatory specialism. On the contrary, a convergent approach to regulation across functions, together with the observed trend towards centralised risk management, points in the opposite direction. To quote Mr. Alan Greenspan, Chairman of the US Federal Reserve Board:

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For instance, IOSCO has recently given prominence to the reduction of systemic risk as a primary objective of securities regulation: See IOSCO (1998) p.8.

13

Insurance should, however, be differentiated for two reasons: first, as explained in the text, systemic risk is less than in banking/securities business and, second, it may not be appropriate to include insurance companies within group consolidated capital adequacy assessment if under relevant insurance legislation capital cannot be transferred to other financial firms within the group.

“One could argue that regulators should only be interested in the entities they regulate and, hence, review the risk evaluation process only as it relates to their regulated entity. Presumably, each regulator of each entity - the bank regulator, the SEC, the state insurance and finance company authorities - would look only at how the risk management process affected their units. It is our belief that this simply will not be adequate. Risks managed on a consolidated basis cannot be reviewed on an individual legal entity basis by different supervisors.”¹⁴

It may also be noted that the new market environment creates a mismatch between functional and institutional regulation - since previously distinct functions now flow over institutional boundaries. In other words a purely institutional approach to regulation would inevitably have to combine different types of financial activity under one regulatory agency; while a purely functional approach would require regulatory agencies to cut across institutional demarcation lines.

Finally, whereas under the segmented financial structure described in Section 1 competitive equality is not a primary concern, within the more fluid competitive environment of overlapping financial activities (e.g. banks competing with investment firms in derivatives markets) regulatory parity becomes a major issue.

SECTION 3: IMPLICATIONS FOR REGULATORY STRUCTURE

In considering institutional structures for financial regulation it is necessary to assess alternative models in terms of economies of scope, regulatory parity (the ‘level playing field’) and (in respect of prudential regulation) what might loosely be termed ‘prudential logic’. Prudential logic refers in particular to the importance of aligning the remit of the regulator with the risk management function of the regulated organisation, so that in the case of centralised risk management of diversified activities, the regulator’s perspective is the same as that of management. A mismatch between the regulator’s unit of assessment on the one

hand, and management's on the other, is likely to lead to trouble (as suggested in Section 2 above).

In the traditional segmented financial structure described in Section 1 a regime of functionally specialised prudential regulators makes sense because different sets of regulatory objectives, techniques and targets are associated with different financial activities. For instance, a traditional-style regulatory framework covering the main areas of activity is summarized in Table 2 below:

TABLE 2. TRADITIONAL STYLE REGULATORY FRAMEWORK			
	TARGETS		
	<u>Banks</u>	<u>Investment Firms</u>	<u>Insurance Companies</u>
OBJECTIVES	Systemic stability Neutralise moral hazard Depositor protection	investor protection	consumer protection
TECHNIQUES	LLR/deposit insurance capital requirements (going concern basis) on-site examinations	liquid capital mark-to-market valuation Segregation of Assets	Actuarial solvency
REGULATOR	central bank/bank regulator	securities regulator	insurance regulator

Within this segmented industry structure there are no obvious economies of scope to be gained, nor is there any prudential logic, in combining specialised prudential regulatory functions within a single regulatory agency. Furthermore, regulatory parity is not a serious issue. On the other hand, conduct of business regulation is concerned primarily with fair treatment of retail depositors, investors and savers. Because in this case regulatory objectives and techniques are similar across different categories of financial activity there is an arguable case for a single conduct of business regulator in terms both of efficiency and regulatory neutrality - regardless of the structure of the financial services industry.

Within the new market environment described in Section 2 above very different considerations apply. Regulation may in this context be divided up in a number of ways, the most important alternative models being as follows:¹⁵

1. Functional regulation
2. Institutional regulation
3. Systemic versus non-systemic institutions
4. Regulation by objective
5. Wholesale versus retail

Under a functional regulation regime specialist regulators focus on the type of business undertaken irrespective of which institutions are involved in that business. Individual institutions might then be subject to several regulatory agencies; there would very likely be a mismatch between regulators' disaggregated approach to risk assessment and the centralised risk management adopted by financial firms; and consolidated supervision becomes problematical. New Zealand may be viewed as an example of functional regulation but problems of regulatory overlap are minimized because of the authorities' emphasis on market forces and strong internal governance incentives as a substitute for detailed official supervision.

A more effective form of functional regulation might be envisaged, however, if regulators were to mandate a corporate structure for diversified firms that seeks to segregate risks associated with different financial activities. Financial conglomerates could be required to operate through a financial services holding company which would conduct its business through specialised operating subsidiaries separated by "firewalls". Those subsidiaries could be subject to functional regulation by specialised regulatory agencies. An element of institutional regulation could then be superimposed in the form of consolidated supervision of the holding company. This model has now been adopted in the US following passage of the Financial Services Modernization Act in 1999 which repealed key provisions of the Glass-Steagall Act. The new US regulatory regime combines umbrella supervision of the consolidated group by the Federal Reserve, regulation of banks by their primary bank regulators and financial regulation of affiliated non bank entities by their respective

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See Goodhart et al. (1998), p.19. Chapter 8 of this study provides a useful discussion of policy issues relating to the institutional structure of regulation.

specialized regulators. However, the main drawback to such an approach, apart from potential regulatory confusion, is that attempts to segregate risks within specialised entities may well prove ineffective and are in direct conflict with the observed trend towards centralised risk management.¹⁶

Institutional regulation, in contrast to functional regulation, demands that regulation be directed at financial institutions irrespective of the mix of business they undertake. It has been argued that under this regime “each institutional regulator would need to apply the business rules appropriate for every function - which would be hugely inefficient in terms of regulatory resources”.¹⁷ However, this view may be overstated: in the context of a single mega-regulator (such as the UK now has - see Appendix 1) all regulation is institutional in the sense that the diversified activities of each institution/group fall within the regulatory remit of a single agency which is also responsible for consolidated supervision. On the other hand, in a regime of multiple regulatory agencies specialised by function, “pure” institutional regulation becomes impossible for the simple reason that institutions are no longer synonymous with functions (although an element of institutional regulation may be introduced through the appointment of a ‘lead regulator’ for diversified groups).

A third possible regulatory divide is between institutions which give rise to systemic risk and those which do not. Since banks are generally viewed as systemically sensitive this might involve a simple distinction between banks and non-banks. However, as explained in Section 2, changes in the market environment have blurred the risk characteristics of banks and non-banks. An alternative approach would be to identify those institutions, whether banks or non-banks, which are of such a size that their default would pose a systemic threat. The difficulty here is that the failure of even small institutions can in some circumstances have systemic consequences. More generally, given the complexity and fluidity of the present market environment it is impractical to identify systemic risk with some specified subset of financial institutions. On the contrary, the interconnectivity between both institutions and markets means that a systemic threat may originate almost anywhere and be transmitted through a variety of institutional channels.

16 See, generally, Dale (1992).

17 George (1996). Cited in Goodhart et al., (1998) Chapter 8.

Another way of dividing up the regulatory function is according to regulatory objective. As noted in Section 1, the relevant prudential objectives in this context are systemic risk, moral hazard and consumer protection while to these must be added consumer protection in the conduct of business sense as well as market integrity. In assessing the merits of this structural model it is important to stress that there has been a convergence both of prudential regulatory objectives (in that systemic risk and moral hazard have become a feature of financial activities other than banking) as well as a convergence of prudential regulatory techniques (reflecting the new supervisory emphasis on value at risk models and internal management controls for all types of financial business). Therefore there is much greater congruence than previously in the prudential regulatory function as it is applied to banks, investment firms, insurance companies etc. The implication is that there are important potential economies of scope to be gained from combining the prudential regulatory function under one regulatory agency. Furthermore, a single prudential regulator embracing all financial business is consistent with centralised risk management practiced by diversified firms and the matching principle of consolidated supervision. Prudential logic therefore points to the desirability of a single prudential regulator which would also be in a position to apply consistent rules across institutions and activities, thereby ensuring regulatory neutrality.

The above is, broadly speaking, the ‘Twin Peaks’ approach advocated by Taylor which would divide regulatory responsibilities between a single prudential regulator (Financial Stability Commission) and a single conduct of business regulator (Consumer Protection Commission).¹⁸ It may be objected that a single prudential regulator would be dealing with three different objectives, namely systemic stability, which calls for a higher degree of risk restraint than the market would provide even without an official safety net; moral hazard which requires regulators to simulate the self-regulatory constraints that would exist in the absence of an official safety net; and consumer protection which is one of the causes of moral hazard. However, since these objectives imply different intensities of prudential regulation, rather than different regulatory techniques, and since systemic risk and moral hazard permeate many areas of financial activity, it would seem neither efficient nor practicable to allocate the objectives to separate regulatory agencies.

18 See Taylor (1995).

It may also be objected that a single prudential regulatory agency would not offer efficiency gains because as a matter of practical necessity there would have to be specialist divisions within the unified agency. Such internal divisions might involve internal transactions costs equivalent to those incurred by separate agencies. While there is no doubt some force in this argument the key point is that where prudential responsibility lies clearly with a single authority the regulatory function and the group managerial function are much more closely aligned. In other words the scope of these two functions is precisely matched, even though the regulatory and managerial objectives may diverge.

Following publication of the findings of the Wallis Committee of Inquiry Australia has adopted a regulatory structure that closely resembles the Twin Peaks model described above.¹⁹ However, the Reserve Bank of Australia retains responsibility for systemic stability and is specifically responsible for safeguarding the payments system. Similarly, following the establishment in the UK of a single mega-regulator the Bank of England retains responsibility for systemic stability.

A key question that arises in this context is whether a central bank that is deprived of prudential regulatory powers (except, perhaps, in respect of the domestic payments system) can meaningfully be responsible for systemic stability - other than in the narrow sense of crisis management. In any event, the supervisory interface between the central bank and the prudential regulatory authority under such a regime assumes great importance (see Memorandum of Understanding between the FSA and the Bank, summarized in Appendix 2).

Finally, regulatory responsibilities may be divided according to whether the financial activity concerned is wholesale or retail, on the grounds that retail users of financial services are in greater need of regulatory protection. The differentiation is particularly relevant for conduct of business regulation but since this distinction, too, relates more to the intensity of regulation than to differences in regulatory technique, there would appear to be efficiency gains in combining wholesale and retail business under one regulatory roof.

19 See Financial System Inquiry (1997).

Assessment

It has been suggested that the convergence of prudential regulatory objectives and techniques relating to previously distinct financial activities has created potential economies of scope in the regulation of such activities. Furthermore, a single prudential regulatory agency is better equipped to conduct consolidated supervision that matches the consolidated risk management practised by diversified financial firms. Finally, regulatory neutrality and consistency is best assured under a unified prudential regulator.

The housing of conduct of business and market integrity regulation within a single conduct of business regulatory agency similarly offers efficiency benefits. However, the case for combining the prudential and conduct of business regulatory functions within a single all-purpose regulatory agency is less obvious given that the techniques and skills required for those functions are different. Even so, it may be argued that compliance with both types of regulatory function is heavily dependent on the attitude of senior management and the adequacy of high-level systems and controls.

Whether the central bank should be the single prudential regulator for all financial activities is a different issue altogether.²⁰ There have been various inconclusive analyses of the appropriate role of central banks in the regulatory process.²¹ However, if, as is increasingly the case, the monetary authority is divested of its prudential regulatory role yet retains responsibility for systemic stability, the ability to exercise that responsibility depends very heavily on the central bank's working relationship with the prudential regulatory authority.

The argument in favour of a single prudential regulator must be modified to the extent that some financial systems, typically in emerging markets, retain the traditional institutional and functional distinctions between banking, securities business, insurance etc.²² Furthermore, in those systems where regulators seek to separate and subsidiarise such activities carried on within diversified financial groups, there may be a case for preserving the traditional structure of regulation based on specialised agencies. Nevertheless, the predominance of the

20 Taylor (1997).

21 See Goodhart and Schoemaker (1993).

22 See Taylor (1998).

specialised regulatory agency model (see Table 3) does suggest that regulatory structures have yet to adapt to recent and on-going changes in financial markets.

**TABLE 3.
THE STRUCTURE OF FINANCIAL REGULATORY AGENCIES**

REGULATORY STRUCTURE	TYPE	COUNTRIES
1. <u>Universal Regulator:</u> Combined banking, securities and insurance regulator	Commission	Australia, Denmark, Japan, Korea, Latvia, Malta, Norway, Sweden, Taiwan, United Kingdom.
	Central Bank or Ministry of Finance	Singapore.
2. <u>Combined Regulator</u> Banking and Securities	Banking and Securities Commission	Belgium, Finland, Hungary, Mexico, Switzerland.
	Central Bank	Bermuda, Cyprus, Dominican Republic, Ireland, Luxembourg, Uruguay.
3. <u>Combined Regulator</u> Banking and Insurance		Austria, Canada, Cayman Islands, Colombia, Ecuador, Guatemala, Kazakhstan, Macau, Malaysia, Paraguay, Peru.
4. <u>Combined Regulator</u> Securities and Insurance		Bolivia, Chile, Czech Republic, South Africa.
5. <u>Individual Specialist Regulator:</u> BANKING	Agency	Bolivia, Chile, France, Germany, United States .
	Central Bank / Monetary Agency	Argentina, Algeria, Barbados, Brazil, Bulgaria, China, Czech Republic, Egypt, Greece, Hong Kong, India, Indonesia, Israel, Italy, Jamaica, Jordan, Kenya, Netherlands, New Zealand, Nigeria, Pakistan, Philippines, Poland, Portugal, Russia, Slovenia, South Africa, Spain, Sri Lanka, Taiwan, Thailand, Turkey, United States , Zambia.
SECURITIES	Agency	Argentina, Austria, Barbados, Brazil, Bulgaria, Canada, China, Columbia, Ecuador, Egypt, France, Germany, Greece, Hong Kong, India, Indonesia, Israel, Italy, Jamaica, Jordan, Kazakhstan, Kenya, Malaysia, Netherlands, New Zealand, Nigeria, Pakistan, Paraguay, Philippines, Poland, Portugal, Russia, Slovenia, Spain, Sri Lanka, Taiwan, Thailand, Turkey, United States , Venezuela, Zambia.
INSURANCE	Agency	Argentina, Barbados, Belgium, Bermuda, Brazil, Bulgaria, China, Egypt, Finland, France, Germany, Hong Kong, India, Italy, Luxembourg, Mexico, Netherlands, Philippines, Poland, Portugal, Russia, Slovenia, Spain, Sri Lanka, Switzerland, United States .

SECTION 4: THE NEW UK REGULATORY ARRANGEMENTS

Prior to the latest reforms, the UK's financial regulatory regime was based on specialised functional regulation involving numerous separate agencies (see chart 1). Within this framework the Bank of England was responsible for the supervision of banks, the Department of Trade and Industry for insurance and the Securities and Investments Board for securities business. In the last case, day-to-day responsibility was devolved to three self-regulatory organisations (SRO's), namely the Personal Investment Authority (conduct of business and financial advisors), the Securities and Futures Authority (securities firms) and the Investment Management Regulatory Organisation (fund managers).

A key feature of this regime was that diversified financial groups were subject to multiple authorisation and supervisory requirements applied by specialist functional regulators. By 1998 eight firms were authorised to conduct all five of the main regulated activities (deposit-taking, insurance, securities and corporate finance, fund management, and advising on or selling investment products to retail customers). A further 13 were authorised to conduct 4 of these activities and over 50 were authorised to conduct three out of the five. This contrasted with the situation twenty years earlier when even the largest UK financial institutions were typically confined to just one, or at most two, of these activities.²³ Clearly, the trend towards multi-functional financial firms was resulting in a new industry structure that did not co-exist easily with a fragmented regulatory system based on regulation by function.

On May 20 1997 the UK Chancellor of the Exchequer, Gordon Brown, surprised the financial world by announcing the decision to create a single UK regulatory agency - the Financial Services Authority (FSA) - with oversight of the entire financial services sector. In a brief explanation of this decision Mr Brown stated:

“It is clear that the distinctions between different types of financial institution - banks, securities firms and insurance companies - are becoming increasingly

23 See Briault (1999), p.13.

blurred. Many of today's financial institutions are regulated by a plethora of different supervisors. This increases the cost and reduces the effectiveness of supervision."²⁴

In subsequent consultations with the financial services industry the Treasury reported that "there was almost unanimous support from consultees for the proposal to have a single statutory regulator, in order to tackle overlaps, gaps and inconsistencies in regulation and impose accountability and clarity of purpose".²⁵ Support from the financial services industry evidently went further than this, with the newly appointed Chairman of the FSA, Howard Davies, remarking in early 1999 that "many international financial institutions have already told us that they see one-stop shop regulation as being a serious competitive advantage for the City ..."²⁶ He concluded that "the new UK regulatory arrangements will increasingly be seen to be a model for appropriate arrangements elsewhere in the world".²⁷

Reflecting the fact that "no other major country has re-engineered the whole of its financial regulation at one time"....²⁸ the new UK arrangements have been phased in. The Financial Services Authority was formally launched in October 1997 and in June 1998 the Bank of England Act 1998 transferred responsibility for banking and wholesale market supervision to the FSA. Meanwhile, pending a formal transfer of other supervisory powers, the various pre-existing regulatory bodies responsible for securities firms, insurance business, building societies, etc. delegated their operational responsibilities to the FSA by way of individual contract, reserving to themselves only formal rule-making and enforcement decisions. In this way the single regulatory agency was created de facto before the relevant legislation came into force. After the Financial Services and Markets Act had received the Royal Assent in June 2000 the FSA acquired its full statutory powers under this statute with effect from December 1st 2001.

24 For the background to this policy initiative and the new statutory framework for regulation in the UK see Blair (2001). See also Briault (2002).

25 HM Treasury 1999 cited in Briault (1999) p.19.

26 See Davies (1999), p.2.

27 See Davies (1999), p.3.

28 See FSA Annual Report 2000/2001, Chairman's Statement.

The FSA is a privately incorporated body that is accountable directly to the Treasury and only indirectly to Parliament for the exercise of its powers. It is subject to various checks, including an independent complaints commission, two independent advisory panels, one representing consumers and the other industry practitioners, and an independent tribunal (the Financial Services and Markets Tribunal) which may be asked to review the FSA's regulatory decisions.²⁹ The agency is funded by the industry it regulates rather than the taxpayer.

The new UK regulatory framework is considered below under the following headings: (1) The FSA's regulatory objectives; (2) the relationship between the Bank of England, the Treasury and the FSA; (3) the internal management structure of the FSA; and (4) the performance of the single regulator to date.

4.1 Regulatory Objectives

The FSA's objectives, which are set out in the new legislation, are (1) to maintain market confidence; (2) to promote public awareness; (3) to protect consumers and (4) to reduce financial crime. Although systemic stability is not specified as a separate objective it is subsumed within market confidence since, "maintaining this confidence involves preserving both actual stability in the financial system and the reasonable expectation that it will remain stable."³⁰

29 For certain types of regulatory decision, the FSA notifies a regulated firm (or approved person) that it intends to take some disciplinary action against them. The firm or person can then either reach a settlement with the FSA, or take their case to the Tribunal. The Tribunal will then hear the case afresh and reach its own independent decision.

30 Financial Services Authority (2000), p.5.

The FSA intends to promote public awareness by improving general financial literacy as well as the information and advice available to consumers.³¹ Under the consumer protection heading the FSA has identified four principal risks facing consumers, namely prudential risk (insolvency of a financial firm), bad faith risk (fraud, misrepresentation), complexity/unsuitability risk and performance risk - the last being primarily a matter for consumers rather than the FSA.³²

31 Financial Services Authority (2000), p.7.

32 Financial Services Authority (2000), p.8.

Finally, under the general heading of financial crime the FSA will focus mainly on money laundering, fraud or dishonesty and criminal market misconduct, including insider dealing.³³

In pursuing these objectives the FSA is required to take account of “principles of good regulation” set out in the legislation. These guiding principles embrace efficient deployment of resources, recognition of senior management’s responsibility (in particular for risk management and controls) ensuring that regulation is proportionate to the resulting benefits, facilitating innovation, maintaining the competitive position of the UK as a financial centre and avoiding regulation that might distort or impede competition. Of special significance is the FSA’s statement that “the proportional approach will manifest itself in particular in different regulatory requirements applied to wholesale and retail markets”³⁴, on the grounds that the latter are less capable of self-protection than the former.

4.2 The Bank of England, the Treasury and the FSA

Perhaps the most delicate aspect of the UK’s new regulatory regime is the relationship between the Bank of England and the FSA since responsibility for maintaining systemic stability is, in general terms, shared between them. In order to clarify the respective roles of the Bank and the FSA and also the Treasury a tripartite Memorandum of Understanding (MoU) was signed in 1997 setting out the parties’ respective responsibilities as well as a framework for mutual co-operation (see Appendix 2).³⁵ The Chairman of the FSA has stated that “the Bank of England has responsibility for the stability of the system as a whole, while we at the FSA are responsible for relationships with all individual financial institutions”.³⁶ In this context, the Bank has a particular responsibility for safeguarding the payments system.

In practical terms, if an institution faces collapse it is for the FSA to make an initial assessment of the systemic threat and to explore the possibility of a market-led rescue. Failing that, the Bank is called upon to assess the nature of the systemic threat and the justification for lender of last resort support, but according to the terms of the MoU Treasury

33 Financial Services Authority (2000), p.9.

34 Financial Services Authority (2000), p.10.

35 Financial Services Authority (1997).

36 See Davies (2001b), p.1.

approval is required before public funds can be put at risk.³⁷ Beyond this the Treasury has no operational responsibility for the activities of the Bank or the FSA, although it must be kept informed of problem situations.

The MoU provides for information-sharing arrangements between the Bank and the FSA which must be robust if the joint responsibility for systemic stability is to be effectively discharged. The Bank's Deputy Governor is a member of the FSA's Board and the FSA Chairman sits on the Court of the Bank. The Memorandum also sets up a Tripartite Standing Committee of representatives of the Treasury, the Bank and the FSA which meets at least monthly to discuss potential systemic threats whether domestic or international. In the view of the FSA's Chairman this forum gives the Bank of England a broader view of financial market issues than was previously the case:

“Of course, when the Bank was a banking supervisor it had a privileged position in the banking system, but it had no formal relationships with securities regulators or insurance supervisors. Now, the Bank's window on the FSA gives it a broader view of financial market developments. As risks are transferred around the financial system, and particularly between banks and investment firms and insurance companies, this new perspective assumes particular significance.”³⁸

The crisis management procedures governed by the Memorandum constitute one of the most important elements of the new UK regulatory regime. However, they have yet to be tested by a major domestic financial disturbance or the failure of a systemically sensitive institution.

4.3 FSA's Management Structure

The question of how to structure a single multi-functional authority involves issues similar to those discussed in Section 3 above. Should the internal management divisions be specialised by regulatory process (e.g. authorisation, supervision, etc.) regulatory objective (e.g.

37 See Davies (1999), p.2.

38 See Davies (2001a), p.2.

prudential versus conduct of business), retail versus wholesale, systemically sensitive versus other institutions, or should there be functional specialisation?

The FSA initially opted for a management structure based mainly on regulatory process.³⁹ Because the process of authorisation was considered to be similar across the financial services industry it was located within a single division. Furthermore, since enforcement involves much the same intelligence base as authorisation these two regulatory activities were combined within the same directorate together with consumer affairs (consumer complaints being related to enforcement).

Supervision of all financial institutions was brought together in a single directorate based on the view that there are important commonalities in supervision of functionally distinct entities. Furthermore, financial institutions themselves evidently supported such an approach because it was felt that it would tend to minimise compliance costs. The FSA introduced into this unitary supervisory structure a system of lead regulation, so that “one individual was made responsible for the consolidated supervision of each financial institution and for co-ordinating the activities of the different, business line regulators relating to those institutions”.⁴⁰

This was the thinking behind the FSA’s initial management structure (see chart 2). However, in the light of its early management experience the FSA made significant changes in this structure with effect from April 2001, (see Chart 3). Most importantly, there has been a shift towards functional regulation, with insurance and investment business being supervised in one directorate and banking and markets/exchanges in another - reflecting the view that the supervision function was simply too large to be undertaken within a single directorate. On

39 See Davies (1997), for the rationale behind the FSA’s managerial structure.

40 See Davies (1997) for the rationale of the FSA’s managerial structure, p.5.

the other hand, multi-functional regulation is preserved for 50 or so major financial groups which are supervised by a new division located within the banking and markets directorate.⁴¹

42

A further structural innovation involves the establishment of a Risk Assessment Division whose function is to identify the risks and opportunities facing the FSA in meeting its objectives, to prioritise the issues for the FSA to work on and to select the most efficient and effective means of implementation.

The new management structure represents a mix of process-driven, objective-driven and functional regulation (see Chart 3). Of the four major regulatory processes (authorisation, standard-setting, supervision and enforcement), authorisation and enforcement are organised on a cross-functional basis, while supervision is in part functionally organised though remaining multi-functional for the largest groups. Standard-setting is different again: although standards are developed on a cross-functional basis, responsibility for conduct of business standards is located in a separate directorate from prudential standard-setting. This contrasts with the supervisory process, where conduct of business and prudential supervision is integrated, albeit divided along functional lines (deposit taking institutions being treated separately). It may be noted that the special regulatory regime applied to major financial groups may be viewed as one means of identifying and responding to possible systemic risks.

4.4 FSA's Performance to Date

The FSA's performance may be assessed in terms of its statutory objectives and the accompanying principles of good regulation. However, given that the UK regulatory regime has been in transition over the past five years and that the FSA only acquired its full statutory

41 "A major financial group is typically large, operating within a complex structure, active in two or more of the main sections of financial business (banking, insurance and investment business) and commonly with extensive international reach." Introduction to the Financial Services Authority, FSA, December 2001, p.13.

42 Groups supervised by the Major Financial Groups Division, though numerically small, account for well over 50% of market share in most sectors of the financial services industry.

powers towards the end of 2001 it is much too early to form any strong conclusions about the new arrangements. Nevertheless, some preliminary judgements may be made about some aspects of the FSA's activities.

First, so far as direct regulatory costs are concerned it would seem that the new regime is more efficient than the multi-agency structure it replaced. The costs of the FSA as a single regulator were budgeted to be lower in real terms in 1999/2000 than the sum of its component parts in either of the two previous years;⁴³ and the budget fell in real terms in each of the following three years.⁴⁴

43 FSA (1999), p.35.

44 Briault (2002), p.16.

It is impossible at this stage to measure the costs of industry compliance if only because there are major transitional/set-up costs for regulated firms. Even so, the Centre for the Study of Financial Innovation (CSFI) has been able to collect some preliminary industry responses to the single regulator regime.⁴⁵ According to the CSFI Report, “on the whole, the City is convinced of the advantages, at least on paper, of the single regulator”.⁴⁶ The FSA is also seen as the most sophisticated and approachable of the European regulators, and the single regulator concept is generally viewed as positive for the City’s international competitive position.

On the negative side there is concern about the allegedly rising costs of regulatory compliance - an increase attributed not to the single regulator regime per se but rather to the shift towards regulatory formalism and rule-based regulation. According to the CSFI Report:

“A typical investment bank now employs about ten compliance personnel for every 1,000 staff, and management spends a good deal of its time on compliance matters, much of it very humdrum. The FSA’s tight budget has not reduced overall regulatory costs, but arguably only shifted them on to the City.”⁴⁷

These criticisms, which were reinforced by a survey conducted for the Financial Services Practitioner Panel published towards the end of 2002,⁴⁸ are most prevalent among smaller firms. Some larger city institutions, especially those classified as “major financial groups”, already claim to be seeing benefits from the new simplified regulatory structure and others expect to benefit in due course. It is also recognised that transition costs are obscuring the likely ongoing compliance costs associated with the new regime. Furthermore, the FSA is in the process of implementing a new risk assessment framework which is intended to introduce a lighter regulatory touch for most regulated firms (see below).

45 See Lascelles (2001). The CSFI study is based on interviews and written responses from over 70 institutions.

46 op cit, p.13.

47 op cit, p.18.

48 2002 Survey of the FSA’s regulatory performance, Report prepared for the Financial Services Practitioner Panel, November 2002.

Just as it is too early to assess the regulatory costs of the FSA it is also much too soon to make judgements about the single regulator's effectiveness. There has, however, been one important and much publicised episode, which highlights the potential for inadequate regulatory co-ordination even within a unified regulatory structure.

Equitable Life is a major mutual life assurance company that, prior to closing its doors to new business in December 2000 managed pension fund assets amounting to nearly £30bn on behalf of some 1 million investors. The company had failed to make provision for guaranteed annuities that were becoming increasingly costly to meet because of the decline in long-term domestic interest rates. By the time the FSA inherited responsibility for regulating Equitable Life the damage had been done and those members of Equitable Life who did not have the benefit of guaranteed annuities were, in effect, going to have to pay for those who did. The FSA initiated an independent review of the handling of this affair (the "Baird Report")⁴⁹ to the Government in October 2001 which identified a number of weaknesses in the FSA's regulatory approach.

Among other matters, the Report noted that there had been inadequate co-ordination and exchanges of information between the prudential and conduct of business regulators within the FSA - the key point being that Equitable Life had been allowed to continue to advertise its services to the public without any reference to the risks involved, long after these risks were known to the prudential regulator. The Report went on to welcome the FSA's subsequent creation of "one division, comprising prudential and conduct of business regulators to deliver integrated supervision of the insurance industry."⁵⁰

One of the lessons to be learned from this episode is that locating all regulation within a single regulatory agency does not guarantee that intra-agency communication and co-ordination will be more effective than communication between separate agencies in a multi-agency regulatory regime. Good supervisory practice is to this extent independent of regulatory structure.

49 See Baird (2001).

50 See Baird (2001), Chapter Seven, Section Seven. The FSA's regulatory response to the Equitable Life debacle is described in detail in 'The Future Regulation of Insurance', FSA, November 2001.

A key innovation developed by the FSA is the newly established risk assessment framework which links the nature and intensity of the supervisory relationship with regulated firms to the FSA's assessment of each firm's potential impact on financial markets and consumers.⁵¹ The intention is to allocate the FSA's resources in the most effective way while also giving firms a greater incentive to behave in ways which reduce their regulatory burden.

Under the new regime each institution is categorised into one of four impact bands, reflecting the firm's importance in terms of the FSA's regulatory objectives. Each firm is also subject to individual risk assessment and categorised into one of four risk categories. High impact firms which are also high risk are then subject to the most intensive supervision, while at the opposite end of the spectrum low-impact/low-risk firms are subject to occasional visits supported by remote monitoring rather than routine inspection.

The risk classification is dynamic and firms are given the opportunity - and incentive - to respond to identified areas of high risk (e.g. inadequate internal controls) by taking prompt remedial action. Corrective initiatives may be rewarded by a reduction in the intensity of supervision in the future, thereby enabling firms to reduce the cost of regulation. The new risk assessment framework may in this way alleviate concerns, noted in the CSFI study referred to above, that the FSA's regulatory approach is excessively heavy-handed and burdensome.

51 See Capps and Linsley (2001).

SECTION 5: SUMMARY AND CONCLUSION

The main considerations behind the regulation of financial institutions are: consumer protection, moral hazard (a consequence of consumer protection), market integrity, and systemic risk. In addition, regulatory neutrality is an important element in the design of any regulatory framework.

In what has loosely been described as the traditional model, the financial services industry is divided into separate pillars (banks, investment firms, insurance companies, and fund management companies) each with its own distinct regulatory regime. Since functions and institutions are synonymous, regulation is both functional and institutional; regulatory neutrality is not a major issue; regulatory objectives, targets, and techniques are neatly compartmentalized; and problems of regulatory interface do not arise.

Over the past decade or so the traditional demarcation lines between banking and non-bank financial activities have been eroded. Ownership linkages between banks and non-banks, the blurring of distinctions between banking and securities business due to “securitization” and other forms of financial innovation, and the dismantling of legal activity constraints previously applied to financial institutions, have together transformed the financial landscape. In the new market environment banks are no longer uniquely susceptible to systemic risk and moral hazard; it is no longer possible to identify separate sets of regulatory objectives, targets, and techniques covering the main categories of financial activity; and there is an inevitable mismatch between the regulation of functions and the regulation of institutions (since function and institution are no longer synonymous).

A further key factor in the new environment is the centralization of risk management within diversified financial firms, using advanced statistical techniques that “unbundle” different types of risk at the individual entity level and re-aggregate them (again by type of risk) for the purpose of centralized management at the group level. Regulators have meanwhile adopted the principle of consolidated supervision, which broadly aligns the regulatory approach to risk appraisal with that of management.

It has been suggested here that the institutional structure of regulation should be assessed in terms of economies of scope, prudential logic, and regulatory neutrality. On this basis the convergence of prudential regulatory objectives and techniques relating to previously distinct financial activities points to the need for a single prudential regulator. There is a parallel, though less compelling, case for the housing of conduct-of-business (and market integrity) regulation within a single regulatory agency. On the other hand, the argument for combining the prudential and conduct-of-business regulatory functions within a single all purpose regulatory body are very evenly balanced, given the different techniques and skills required for those functions.

Consistent with the above principles, the UK has responded to the changing regulatory needs of the financial services industry by integrating all regulatory functions within a single multi-functional agency. UK financial institutions have, in general, welcomed this new structure which replaces a regime based on nine separate regulatory agencies. It is too early to judge the success of the UK approach although, understandably, there have been some initial difficulties. The FSA has felt it necessary to adapt its original internal organizational structure, it has been criticized for lack of co-ordination between its prudential and conduct-of-business regulatory functions and UK firms have voiced concerns about the costs of regulatory compliance under the new arrangements. However, as explained above, the FSA has reacted comprehensively to these criticisms and would seem that the problems encountered so far are those that might be expected in the early stages of a major overhaul of the entire financial regulatory framework.

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APPENDIX: 2

Memorandum of Understanding between the UK Treasury, the Bank of England and the Financial Services Authority: Summary of issues addressed.

1. Bank of England's Responsibilities

The Bank will be responsible for the overall stability of the financial system, involving:

- (ii) Stability of the monetary system.
- (iii) Financial system infrastructure, in particular the payments system.
- (iv) Advice on implications for financial stability of domestic and international financial market developments.
- (v) Role as lender of last resort.
- (vi) Efficiency and international competitiveness of the financial sector.

2. FSA's Responsibilities

The FSA will be responsible for:

- (i) The authorisation and prudential supervision of banks, building societies, investment firms, insurance companies and friendly societies.
- (ii) The supervision of financial markets and clearing and settlement systems.
- (iii) The conduct of support operations, other than lender of last resort assistance, involving, for instance, changing capital or other regulatory requirements and capital injections into troubled firms by third parties.
- (iv) Regulatory policy in the above areas.

3. The Treasury's Responsibilities

The Treasury is responsible for the institutional structure of regulation and the legislation that governs it. It has no operational responsibility for the activities of the Bank or the FSA but it is to be kept informed of problem situations so that the Chancellor may be given the opportunity of refusing support action.

4. Co-operation between the Bank and the FSA

The Bank's Deputy Governor will be a member of the FSA's board and the FSA Chairman will sit on the Court of the Bank. The FSA and the Bank will establish information sharing arrangements. There will be a standing committee of representatives of the Treasury, Bank and SFA which will discuss financial stability issues on a monthly basis (and at other times as needed).