# Financial markets: supervisory and structural reform – the draft *Financial Services Bill*

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Ever since the Northern Rock Bank failed in September 2007, the UK financial regulatory authorities have looked at how they operate and whether changes were needed to the existing system. The deepening crisis in 2008 and 2009 expanded the breadth of this review both in the UK and across the world.

There have been two major developments in 2011. First, the publication of the draft Financial Services Bill and, secondly, the publication of an Independent Commission's Report headed by Sir John Vickers.

This note sets out some of the background; sets out the broad outlines of current government proposals as contained in the draft Financial Services Bill. Another standard note (SN/BT/6171) summarises the Vickers proposals.

## Contents

## 1 Introduction

If there is to be a new financial regulation Act in 2012, as looks likely, it will continue a trend of 12 year life spans of regulatory systems. Rather like dealing with a slippery fish, successive governments have grappled with the constant twin problems of supervision and regulation.[1] Clearly, there can be a substantial overlap between these concepts.

The fish is slippery because financial markets change and evolve. In the 1970s it was a London – centric system based on relatively few organisations working on functional lines – where the Governor's 'eyebrows' operated with effect within a defined 'club' of well established firms and known individuals. The 1985 'big bang' transformed the City into a world centre open to, particularly, the influences of American investment banks which trampled down existing demarcation lines and were unaware of the meaning of anyone's eyebrows. From the turn of the last century, financial innovation combined with advances in technology again transformed the now global financial landscape now dominated by huge banking groups offering an exhaustive range of banking services from the exotic to the retail.

Each stage of development revealed weaknesses in the existing prudential framework and prompted the need for change.

## 2 Previous and current regulatory systems

The system, if it warrants such a title, up to 1986 was a collection of largely single industry Acts, clustered around the Prevention of Fraud (Investments) Act 1958, supplemented by various Companies Acts provisions. It was administered by either the Department responsible, often the then Department of Trade & Industry (DTI), or by self-regulating bodies, for example Lloyds or the Stock Exchange. On the back of a series of financial scandals in the late 1970s the DTI commissioned a Report by Professor Gower "to advise on the need for new legislation".[2]

Gower found much to criticise. The current system had, he said, the following defects:

> complication, uncertainty, irrationality, failure to treat like for like, inflexibility, excessive control in some areas and too little (or none) in others, the creation of an elite and a fringe, lax enforcement, delays, over concentration on honesty rather than competence, undue diversity of regulations and regulators, and failure overall to achieve a proper balance between Governmental regulation and self regulation.[3]

Working within what he saw as the political constraints of the day

> "Unless the City gravely blots its copy book, I cannot picture a Government of any complexion forcing a (US Securities Exchange type) commission upon it in the near future".[4]

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[1] Supervision is normally taken to mean an overall view of how the markets are working and how to deal with a major crisis. Regulation refers to the more micro aspects of the rules of conduct individual firms are required to follow. Together they may be referred to as the prudential framework.

[2] Review of Investor Protection; Cmnd 9125, January 1984

[3] Ibid para 10.04

[4] Ibid p91

Gower proposed and the then government accepted a system comprised of a series of self-regulatory agencies but which would operate within a much broader and more inclusive statutory framework. The result was the *Financial Services Act 1986.*

### 2.1 Financial Services Act 1986

The Act was passed in November 1986 and came into force on 29 April 1988. Departmental responsibility initially rested with the DTI but was subsequently transferred to the Treasury. The Department delegated many of its powers under the Act to the sole top tier regulator the Securities and Investments Board (SIB). Under the system, SIB set the overall framework for the detailed standards of regulation, and consulted on and initiated policy objectives. Below SIB were a number of Self Regulating Organisations (SROs); Recognised Investment Exchanges (RIEs); Recognised Professional Bodies (RPBs), and Recognised Clearing Houses (RCHs).

The SROs were the most prominent of the regulators. Investment firms had to be authorised by an appropriate SRO if they wanted to conduct investment business in the United Kingdom. The SROs were funded and in part managed by the investment firms which belonged to them. For this reason, the style of regulation was known as self-regulation. At first, there were five SROs but later (after 1994) there were three: the Securities and Futures Authority, the Investment Managers' Regulatory Organisation and the Personal Investment Authority.

Although the deposit-taking activities of UK banks were regulated by the Bank of England, when banks sold investment services, they were regulated in that area by a Self Regulating Organisation. This division of responsibilities was altered by the *Bank of England Act 1998*, which is part of the present Government’s regulatory changes, and which transferred the regulation of deposit-taking by banks to the SIB (renamed the Financial Services Authority).

The regulatory system set up by the *Financial Services Act 1986* suffered persistent criticism right from the start. The industry was critical of the costs it imposed on the industry, and found the ever-changing regulations expensive to comply with. However, outside critics felt that the self-regulatory structure still favoured the industry rather than the investors, and that whilst the system was expensive, its costs were not proportionate to the degree of investor protection which it provided.

Bearing in mind Professor Gower’s comment about ‘blotting the copy book’, arguably the ink was spilt in 1991 in the aftermath of the disappearance of Robert Maxwell. The subsequent discovery of the theft of assets from Maxwell company pension funds lead to criticism of the way that IMRO, the SRO for the investment management sector, had discharged its regulatory responsibilities.

In 1992, in the wake of Maxwell the then Chairman of the SIB, Andrew Large, was asked by the Chancellor of the Exchequer to carry out a review of the effectiveness of SIB’s regulatory role. Large conducted what he described as a ‘personal review’, and published his conclusions in *Financial Services Regulation: Making the two tier system work*. [5]

SIB had already conducted its own investigation into the performance of IMRO in the Maxwell affair (as had IMRO). The regulators concluded that IMRO’s monitoring had been too mechanistic and that it had treated information which it received uncritically. It had no

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5 Andrew Large, *Financial Services Regulation: Making the two tier system work*, Securities and Investments Board, May 1993

procedures to identify potential risks, and when the problems were revealed it failed to act quickly enough. SIB concluded that it too had been at fault in not identifying the regulatory shortfalls at IMRO.

At the time of the Large report, a number of other challenges faced the regulators. The structure of regulation for retail investors was under review, and a report, as part of SIB's Retail Regulation Review, had been prepared by Sir Kenneth Clucas which recommended the creation of a new SRO for the retail investment sector. This was to lead to the creation of the Personal Investment Authority in 1994. Also in the background of the Large report was a looming problem with the sale of home income plans (which proved very unsuitable for the elderly investors who had bought them), and investigations into events at the London Fox futures market.

Large identified a number of problems which the regulatory regime was perceived to suffer from. These included a lack of clarity in the objectives of the *Financial Services Act*; a perception that self-regulation was the same as self-interest; doubts about the cost-effectiveness of the regulatory system; and a feeling that fraud was allowed to go unpunished. Large concluded that many of these criticisms were justified, and that SIB should take a more active leadership role in the future, and aim for greater transparency in regulation.

The Treasury Select Committee started its own wide ranging review of financial services regulation in January 1994. As well as the main report, *The Regulation of Financial Services in the UK*, it issued a number of interim reports on building societies, Lloyd's of London, and retail financial services. The Committee picked up the baton from Andrew Large's review, and investigated whether progress had been made in addressing weaknesses in the regulatory system. It called for the Bank of England's role as the banking regulator to be reviewed, and floated the possibility of a free standing regulator for banks and building societies.[6] Its solution for the confusion of responsibilities between regulators was to concentrate departmental responsibility solely in the Treasury.[7] The Committee had earlier looked at the *Role of the Bank of England* in a separate report, where it felt inclined to retain supervision in the Bank although it recognised that that position would need to be reviewed were a wholesale reorganisation of financial services regulation to take place.[8]

Celebrated regulatory failures across the spectrum of financial services provision and public and industry lack of confidence in the system combined with a change of government in 1997.

### 2.2 Financial Services & Markets Act 2000

A pledge to address the regulatory structure had been included in the Labour Party's 1997 Business Manifesto[9] and, on 20 May 1997, in a statement to the House, the then Chancellor, Gordon Brown, announced wide ranging plans to reform the structure of financial regulation and to transfer banking supervision from the Bank of England to an enhanced city regulator based on the existing pattern of SIB.

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6 Treasury and Civil Service Committee, *The Regulation of Financial Services in the UK*, 23 October 1995, HC 332-I, 1994-95, para 10

7 Ibid., paras 113, 118-19

8 8 December 1993, HC 98-I, 1993-94, paras 102-03

9 *Labour's Business Manifesto: Equipping Britain for the future*, April 1997

There is therefore a strong case in principle for bringing the regulation of banking, securities and insurance together under one roof. Firms now organise and manage their businesses on a group-wide basis. Regulators need to look at them in a consistent way. That would bring the regulatory structure closer into line with today's increasingly integrated financial markets. It would deliver more effective and efficient supervision, giving both firms and customers better value for money, and would improve the competitiveness of the sector and create a regulatory regime to genuinely meet the challenges of the 21st century.

I have decided to take the opportunity presented by the Bank of England reform Bill that we will introduce to reform the regulatory system. Responsibility for banking supervision will be transferred, as soon as possible after passage of the Bill, from the Bank of England to a new and strengthened Securities and Investments Board, which will also, as a result of forthcoming legislation, take direct responsibility for the regulatory regime covered by the Financial Services Act.

The Securities and Investments Board will become the single regulator underpinned by statute. The current system of self-regulation will be replaced by a new and fully statutory system, which will put the public interest first, and increase public confidence in the system.

The Governor of the Bank of England will be fully involved in drawing up the detailed proposals. The Bank will remain responsible for the overall stability of the financial system as a whole. The enhanced Securities and Investments Board will be responsible for prudential supervision.[10]

It was controversial at the time to remove bank supervision from the Bank of England, and that controversy reached new heights during the post mortem on the collapse of Northern Rock.

Twelve years after the *Financial Services Act* system came into force, the *Financial Services and Markets Act 2000* was passed. At the head of the system was a renamed SIB, now called the Financial Services Authority (FSA), whose sphere of responsibility has widened significantly during the course of its existence, for example assuming responsibility for general insurance matters and mortgages. As important as the setting up of the FSA was the reorganisation of the Bank of England. This was done by the *Bank of England Act 1998* which transferred banking supervision to the renamed FSA; it also formalised the Bank's newly acquired role of administering monetary policy, and made changes to the Bank's Court

The key elements of the new structure were:

- The two-tier regulatory system of the Securities and Investments Board and self-regulating organisations were replaced by a single regulator - the Financial Services Authority (FSA).
- Responsibility for banking supervision was transferred from the Bank of England to the FSA by the *Bank of England Act 1998*
- Self-regulation was replaced by a 'new and fully statutory system'.
- Practitioner involvement was retained.
- Wholesale and retail markets would be subject to different levels of regulation.

[10] HC Deb 20 May 1997 cc 509-11

In the light of what was to follow, the reaction of the Bank of England to the new structures is of particular interest. The Bank, including the then Governor, had already made its opposition clear to a transfer of banking supervision from the Bank at the time the *Bank of England Bill* was under discussion. At the time of the Chancellor's announcement, it became apparent that the Bank had barely been kept informed of the new Government's plans. The Financial Times reported the Governor telling Bank staff 'that he had not been consulted about the decision to strip the Bank of its traditional supervisory powers'.[11] Mr George was also reported to have considered resigning over the move, although perhaps only in passing.[12] The Bank's official response, which quoted the Governor in a press release issued on the day of the Chancellor's announcement, was studiously guarded. It noted that the Bank was only informed of the decision on the previous day.

> What matters is not the Bank's position but the whole structure of financial regulation and what is best both for depositor, investor and policy-holder protection, on the one hand, and for systemic stability, on the other.
>
> We have never argued that banking supervision for the purpose of depositor protection must necessarily be undertaken in the central bank. We have recognised that changes in financial markets are blurring traditional distinctions between banks and other financial intermediaries. Nevertheless, banks remain of special systemic importance, because of their unique role as providers of liquidity, to both depositors and borrowers, including their central role in payments and settlements, and because their resulting unsecured exposures to each other make them particularly vulnerable to contagion from elsewhere in the system. For these reasons it will continue to be important under the new arrangements that the central bank is able to monitor, through the new regulatory body, the financial condition of individual institutions, as well as that of the system as a whole.[13]

## 3 The call for reform

A full review of the early period of the FSA's work can be found in a Library standard note (Financial Services authority: looking forward looking back)[14] this note was published in July 2007, barely two months before the collapse of Northern Rock and the start of much else.

The timing is perfect for the light it throws on what was generally thought to be the normality of the then regulatory system. It looks at the issue of enforcement – comparing the more aggressive US response to the FSA's lower key attitude; the success of the transition from one system to the other; the overblown and onerous rule book (in the early years) but mainly it looks at the guiding mantra of 'principles based regulation'.

This principle, it was thought, allowed a 'light-touch' system which promoted the competitiveness of London. The Mansion House speech of the FSA's then Chairman, given on 20 September 2005, summed up many commentators thoughts on the role and position of the regulator.

> As a broad generalisation, I would say that the wholesale financial services markets are characterised by significant, even fierce, competition, with a range of providers of services competing for the business of for the most part informed and competent potential customers.

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11 'Bank to lose supervisory role', *Financial Times*, 21 May 1997

12 'Governor thought of quitting over Bank proposals', *Financial Times*, 22 May 1997

13 'Transfer of banking supervision', Bank of England press release, 20 May 1997

14 SN/BT 3787

> These happy circumstances allow us to adopt lighter touch regulation where we can rely on the precept of caveat emptor – a principle which has informed our recent statements on the trading of debt instruments; and has enabled us to encourage the industry to develop its own solutions (as we have done with bundled services for asset managers, and are doing for contract certainty in the insurance market), and generally to keep regulatory intervention as a backstop.

The FSA was not the only national regulator to have cause to regret relying on caveat emptor.[15] The standard note could not find any definitive measures of success or failure in the new system but could at least conclude:

> Lastly, it is worth making the point that there has been no major financial crisis or scandal that has emerged entirely under its watch. Endowment mortgages predate it by decades, even the [investment trust] 'splits' had their genesis under the previous regime.[16]

Within a few weeks, the FSA had to defend itself against charges that it had 'fallen asleep on the job' and its record of supervision of Northern Rock appeared weak. It launched a full and frank internal review of its own actions which revealed many weaknesses.

But it was not just the FSA on trial; also in the 'dock' was the 'tripartite framework'.

### 3.1 The tripartite framework

When supervision for banks was taken from the Bank of England and given to the FSA, the Bank still retained responsibilities for financial stability. The fact that the FSA was made independent of government and was therefore the source of most legislation did not mean that the Treasury retained no responsibility either. Thus was the tripartite framework formed: FSA, Bank and HM Treasury.

The relationship between the bodies is governed by a Memorandum of Understanding (MoU).[17] Each of the bodies has unique functions.

The Bank of England:

> i. ensuring the stability of the monetary system as part of its monetary policy functions. It acts in the markets to deal with fluctuations in liquidity;
>
> ii. overseeing financial system infrastructure systemically significant to the UK, in particular payments systems whether based in the UK or abroad. As the bankers' bank, the Bank stands at the heart of the payments system. It falls to the Bank to advise the Chancellor, and answer for its advice, on any major problem arising in these systems. The Bank is also closely involved in developing and improving the infrastructure and strengthening the system to help reduce systemic risk;
>
> iii. maintaining a broad overview of the system as a whole. The Bank is uniquely placed to do this, being responsible for monetary stability and having representation on the FSA Board (through the Deputy Governor (financial

15 former Federal Reserve Chairman Alan Greenspan, in testimony to a Congressional Committee denied the nation's economic crisis was his fault but conceded the meltdown had revealed a flaw in a lifetime of economic thinking and left him in a "state of shocked disbelief."

16 SN/BT/3787 p18

17 Hhttp://www.hm-treasury.gov.uk/documents/financial_services/regulating_financial_services/fin_rfs_mou.cfmH (ret'd 11/10/07)

stability)). Through its involvement in markets and payments systems it may be the first to spot potential problems. The Bank advises on the implications for UK financial stability of developments in the domestic and international markets and payments systems and assesses the impact on monetary conditions of events in the financial sector;

iv. undertaking, in exceptional circumstances, official financial operations, in accordance with the arrangements in paragraphs 13 and 14 of this Memorandum, in order to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system.

The FSA:

i. the authorisation and prudential supervision of banks, building societies, investment firms, insurance companies and brokers, credit unions and friendly societies;

ii. the supervision of financial markets, securities listings and of clearing and settlement systems;

iii. the conduct of operations in response to problem cases affecting firms, markets and clearing and settlements systems within its responsibilities, where:
a) the nature of the operations has been agreed according to the provisions of paragraphs 13 and 14 of this Memorandum; and
b) the operations do not fall within the ambit of the Bank defined in paragraph 2 above. (Such operations by the FSA may include, but would not be restricted to, the changing of capital or other regulatory requirements and the facilitation of a market solution involving, for example, an introduction of new capital into a troubled firm by one or more third parties.)

iv. regulatory policy in these areas, including that intended to promote the resilience to operational disruption of authorised firms and Recognised Bodies. The FSA advises on the regulatory implications for authorised firms and Recognised Bodies of developments in domestic and international markets and of initiatives, both domestic and international, such as EC directives.

The Treasury:

i. the overall institutional structure of financial regulation and the legislation which governs it, including the negotiation of EC directives;
ii. informing, and accounting to Parliament for the management of serious problems in the financial system and any measures used to resolve them, including any Treasury decision concerning exceptional official operations as set out in paragraphs 13 and 14; and
iii. accounting for financial sector resilience to operational disruption within government.

MOU was first published at the same time as the *Bank of England Bill 1997*.[18] It was modified in 2006. The 2006 MOU can be found on the Bank's website.[19] Some sort of MOU was essential consequent upon the decision by the then Chancellor, Gordon Brown, to take direct supervision of banks away from the Bank of England and give it to the FSA. In light of subsequent discussions about the role that this decision played in subsequent events, the

[18] HC deposited paper Dep 99/1398. A version was reproduced in the *Bank of England Quarterly Bulletin* May 1998, p97
[19] Bank of England website at: http://www.bankofengland.co.uk/financialstability/mou.pdf

comments of the then Governor, Sir Eddie George, are worth recording. In a speech at the Mansion House in June 1997, he said:

> Weighing these considerations I can see the case for separation - on grounds of the potential conflict of objectives. And I certainly will not mourn the passing of the criticism - whether or not it is justified - that is visited upon the banking supervisor whenever a significant bank does in fact fail - as will inevitably happen from time to time. The key question now is how best to minimise the practical disadvantages of separation, in terms of the Bank's responsibilities for monetary and systemic financial stability, by ensuring that we preserve very close links with the super-SIB[20], including particularly those within the SIB who will have responsibility for banking supervision. I have no doubt that we will indeed be able to establish the necessary close relationship - in our mutual interest - not least because the new super-SIB will be headed by our own Deputy Governor, who will be taking many of our own banking supervisors with him.[21]

The extent to which the three bodies worked together and whether the system they operated was actually workable in a crisis, became one of the main subjects of debate in the early stages of the crisis.

An important arm of the system had been the Standing Committee on Financial Stability. This was chaired by the Treasury with representatives from all three arms attending. The normal (and extraordinary) modus operandi of the Committee is set out in the following paragraphs from the Memorandum:

> 11. Standing Committee meets on a monthly basis at deputies (official) level to discuss individual cases of significance and other developments relevant to financial stability. Meetings can be called at other times by any of the participating authorities if it considers there to be an issue which needs to be addressed urgently. Each authority is to have nominated representatives who can be contacted, and meet, at short notice.
>
> 12. A sub-group of Standing Committee co-ordinates the authorities' joint work on financial sector resilience to operational disruption and maintains and tests tripartite arrangements for effective crisis management in an operational disruption.
>
> 13. In exceptional circumstances, for instance where a support operation is being considered, the Standing Committee meets at principals level, comprising the Chancellor of the Exchequer, the Governor of the Bank and the Chairman of the FSA (or senior alternates). The Bank and the FSA are each to assess, from the perspective of their distinct responsibilities and expertise, the seriousness of the crisis and its potential implications for the stability of the financial system as a whole. They will each provide their separate assessments to the Treasury, together with their views on the options available to the Chancellor. Standing Committee may then discuss the appropriate use of measures and ensure effective co-ordination of the response, while respecting the formal responsibilities of the three authorities (subject to paragraph 14).

Paragraph 14 is the section of the Memorandum that is of application to the fortnight from about the second week of September 2007. It deals with a financial crisis:

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[20] Note: SIB (Securities and Investments Board) was the predecessor body to the FSA, at the time of the original MOU the FSA had not yet been brought into being on a statutory basis.

[21] Mansion House Speech 12 June 1997

14. In exceptional circumstances, there may be a need for an operation which goes beyond the Bank's published framework for operations in the money market. Such a support operation is expected to happen very rarely and would normally only be undertaken in the case of a genuine threat to the stability of the financial system to avoid a serious disturbance in the UK economy. If the Bank or the FSA identified a situation where such a support operation might become necessary, they would immediately inform the other authorities and invoke the co-ordination framework outlined in paragraph 16 below. Ultimate responsibility for authorisation of support operations in exceptional circumstances rests with the Chancellor. Thereafter they would keep the Treasury informed about the developing situation, as far as circumstances allowed.

15. In any such exceptional circumstances, the authorities' main aim would be to reduce the risk of a serious problem causing wider financial or economic disruption. In acting to do this, they would seek to minimise both moral hazard in the private sector and financial risk to the taxpayer arising from any support operation.

16. The authorities maintain a framework for co-ordination in the management of a financial crisis. This includes arrangements that determine which authority would take the lead on particular problems arising and for ensuring orderly communication with market participants and overseas authorities. Each authority would assess the situation and co-ordinate their response within the framework agreed with the other authorities. The form of the response would depend on the nature of the event and would be determined at the time; and where possible and desirable to facilitate a solution to a problem, and hence reduce risks to wider financial stability, encourage negotiations between third parties whose agreement might be beneficial for the reduction or resolution of the issue, in its area of responsibility.[22]

### *The Financial Services Bill*

In recognition of weaknesses in the workings of the tripartite arrangement exposed by the crisis, the Labour government introduced various reforms to the system as part of its *Financial Services Bill*.[23] Consideration had already been given to changing the tripartite arrangements in the build up to the *Banking Bill 2008* (an earlier post-crisis reform measure). The Treasury consultation paper *Financial Stability and Depositor Protection: strengthening the framework* [24] noted that:

Coordination in the UK

1.54 In the UK, the coordination of the work of the Authorities is set out in a tripartite Memorandum of Understanding (MoU) originally agreed in 1997 and modified in 2006.

1.55 As supported by the Treasury Select Committee, the Authorities believe that the tripartite structure continues to be the right approach for the UK. However, the Authorities propose to make a series of changes to make these tripartite arrangements more effective in future, so:

- the Authorities intend to apply some of the lessons from the operation of COBR to the working of the tripartite arrangements;

[22] Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority; http://www.hm-treasury.gov.uk/documents/financial_services/regulating_financial_services/fin_rfs_mou.cfm

[23] *Financial Services Bill*, Bill 6 2009/10

[24] *Financial Stability and Depositor Protection: strengthening the framework* , Cm 7308; Treasury website at: http://www.hm-treasury.gov.uk/media/3/5/banking_stability_pu477.pdf

the FSA and the Bank of England will consider the scope for greater combined initiatives to develop common understanding;

the Authorities propose to clarify responsibilities within the MoU for decisions around providing support to firms – in particular emergency liquidity assistance

The *Financial Services Bill* would have replaced the Standing Committee with a Council for Financial Stability. Since, the Council retained the same participants as its predecessor, and since, its terms of reference were only ever produced in draft form [25] it is difficult to imagine what changes might have accrued from the new arrangements. Clearly, there are areas of similarity and difference between the intended Council and its predecessor. Some of these were drawn out by the Treasury White Paper and are shown in the table below.

| | **Council for Financial Stability** | **Tri-partite system** |
|---|---|---|
| Constitution | Established by forthcoming statute | Non-statutory. |
| Membership | Will be chaired by Chancellor; possible participation by external members from other bodies allied to Bank, FSA and Treasury. | Membership limited to tripaprtite members; normally chaired at official level. |
| Advice | Access to Bank's *Financial Stability Report* & FSA's *Financial Risk Outlook.* | Access to Bank's *Financial Stability Report* & FSA's *Financial Risk Outlook.* |
| Transparency | Minutes will be published but "a significant proportion..will not be suitable for publication". | No minutes published. |
| Accountability | Annual Report describing CFS activities to be presented to Parliament. | No report. |
| External policy work | CFS will "discuss and coordinate UK authorities' position on EU and international financial stability and regulatory policy issues. | Currently Treasury responsibility. |

*Source: CM 7667, p49*

In the event, the passage of the Bill was interrupted by the 2010 General Election and the legislative ‘wash-up’ which preceded it. The Bill was passed but several clauses, including those affecting the tripartite authorities, were abandoned.

A general discussion of many of the issues affecting high level supervision can be found in the Report by the Treasury Committee which looked at reform in its July 2009 report, *Banking crisis: regulation and supervision*.[26] The Committee cautiously welcomed the proposal to replace the tripartite arrangements with a Council for Financial Stability, although it saw this change as largely cosmetic. It argued that clarity was needed on the tools necessary for “macroprudential regulation” before deciding who should use those tools. Whatever the final outcome, it was imperative that responsibilities were clear:

> 113. We cautiously welcome the replacement of the Tripartite Standing Committee by the Council for Financial Stability (CFS) in respect of the publication of clear terms of reference for the new body and the fact that minutes of its meetings will now be published. We look forward to engaging with the CFS over how Parliamentary

25 Available from Treasury website: Hhttp://www.hm-treasury.gov.uk/d/fin_bill_tor.pdf
26 Treasury Committee, Fourteenth Report of 2008-09, HC 767

accountability might be improved. However, we view the change as one which is largely cosmetic. Merely rebranding the Tripartite Standing Committee will achieve little by itself; what is required is an improvement in cooperation amongst its members, and a simplification and clarification of responsibilities for each of its members.

114. Devising an appropriate institutional framework for macroprudential supervision is extremely important and should not be rushed. We agree with the argument made by each of the Chancellor, the Governor and the Chairman of the FSA that it is necessary to reach an agreement on the precise instruments needed in the macroprudential toolbox, before considering which organisation should wield those tools.

115. Whatever the final outcome of any institutional arrangements it is absolutely imperative that responsibilities are clear. The biggest failings of the Tripartite's handling of Northern Rock were that it was not clear who was in charge, and, because the Tripartite took a minimalist view of their respective responsibilities, necessary actions fell between three stools. We are not confident that this issue has yet been adequately resolved. Where before no-one had a formal responsibility for financial stability, now many do—the Bank of England, the FSA, the Treasury, the Council for Financial Stability and the Bank's Financial Stability Committee. Where responsibility lies for strategic decisions and executive action was, and remains, a muddle. The Treasury's design of the institutional framework for financial stability must bear in mind that, when the dust eventually settles on a new system, the question that we, and others, will ask is "Who gets fired?" if and when the next crisis occurs. It is a blunt question, but one which is necessary. Only if we have such clear responsibilities can we expect good decisions to be made and the right actions to be taken. Once those responsibilities have been clarified, the appropriate powers must be properly aligned.

# 4 Post General Election proposals

## 4.1 The prudential framework

In July 2010, the Government published a Green Paper on regulatory reform – *A new approach to financial regulation*.[27] The Government wants to change the existing regulatory system known as the tripartite authorities which are the Bank of England, the Treasury and the FSA. The Green Paper identified the reasons why the Government thought the old system had failed:

it places responsibility for all financial regulation in the hands of a single, monolithic financial regulator, the Financial Services Authority (FSA), which is expected to deal with issues ranging from the safety and soundness of the largest global investment banks to the customer practices of the smallest high-street financial adviser;

A new approach to financial regulation: judgement, focus and stability

it gives the Bank nominal responsibility – and, since the Banking Act 2009, statutory obligations – for financial stability, but does not provide it with the tools or levers to carry out this role effectively; and

it gives the Treasury responsibility for maintaining the overall legal and institutional framework, but no clear responsibility for dealing with a crisis which put tens of billions of pounds worth of public funds at risk.

Perhaps the most obvious failing of the UK system, however, is the fact that no single institution has the responsibility, authority or powers to monitor the system as a whole, identify potentially destabilising trends, and respond to them with concerted action.

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27 HM Treasury, HA new approach to financial regulation: judgement, focus and stabilityH, Cm 7874

This is a problem which Lord Turner, the chairman of the FSA, and Paul Tucker, Deputy Governor of the Bank for financial stability, have referred to as ‘underlap’: a phenomenon whereby macro-prudential risk analysis and mitigation fell between the gaps in the UK regulatory system.[28]

The specific proposals contained in the document are set out below:[29]

First, there must be a dedicated focus on macro-prudential analysis and action, to ensure that risks developing across the financial system as a whole are identified and responded to. That is why the Government will create a new **Financial Policy Committee** (FPC) in the Bank of England, with primary statutory responsibility for maintaining financial stability.

[...]

Second, the regulatory architecture has to ensure that macro-prudential regulation of the financial system is coordinated effectively with the prudential regulation of individual firms, and that a new, more judgement-focused approach to regulation of firms is adopted so that business models can be challenged, risks identified and action taken to preserve stability.

That is why the Government will transfer operational responsibility for prudential regulation from the FSA to a new subsidiary of the Bank of England. This new **Prudential Regulation Authority** (PRA) will be responsible for prudential regulation of all deposit-taking institutions, insurers and investment banks. The PRA will have a board chaired by the Governor of the Bank, and a chief executive who will also be the newly created Deputy Governor for prudential regulation.

[...]

The Government will therefore create a dedicated **Consumer protection and markets authority** (CPMA) with a primary statutory responsibility to promote confidence in financial services and markets. This objective will have two important components. First, the protection of consumers through a strong consumer division within the CPMA. And second, through promoting confidence in the integrity and efficiency of the UK’s financial markets.

In its consumer-focused role, the CPMA will therefore take on all the FSA’s responsibilities for conduct of business regulation and supervision of all firms, as well as arms-length oversight of the Financial Ombudsman Service, the Consumer Financial Education Body, and the Financial Services Compensation Scheme. The creation of a regulator with specific responsibility for consumer protection will ensure that the interests of consumers are not forgotten about or subordinated.

1.23 At the same time, a markets division within the CPMA will regulate all aspects of the conduct of participants in wholesale markets, as well as various elements of market infrastructure such as investment exchanges. The CPMA markets division will also represent the UK at the new European Securities and Markets Authority.

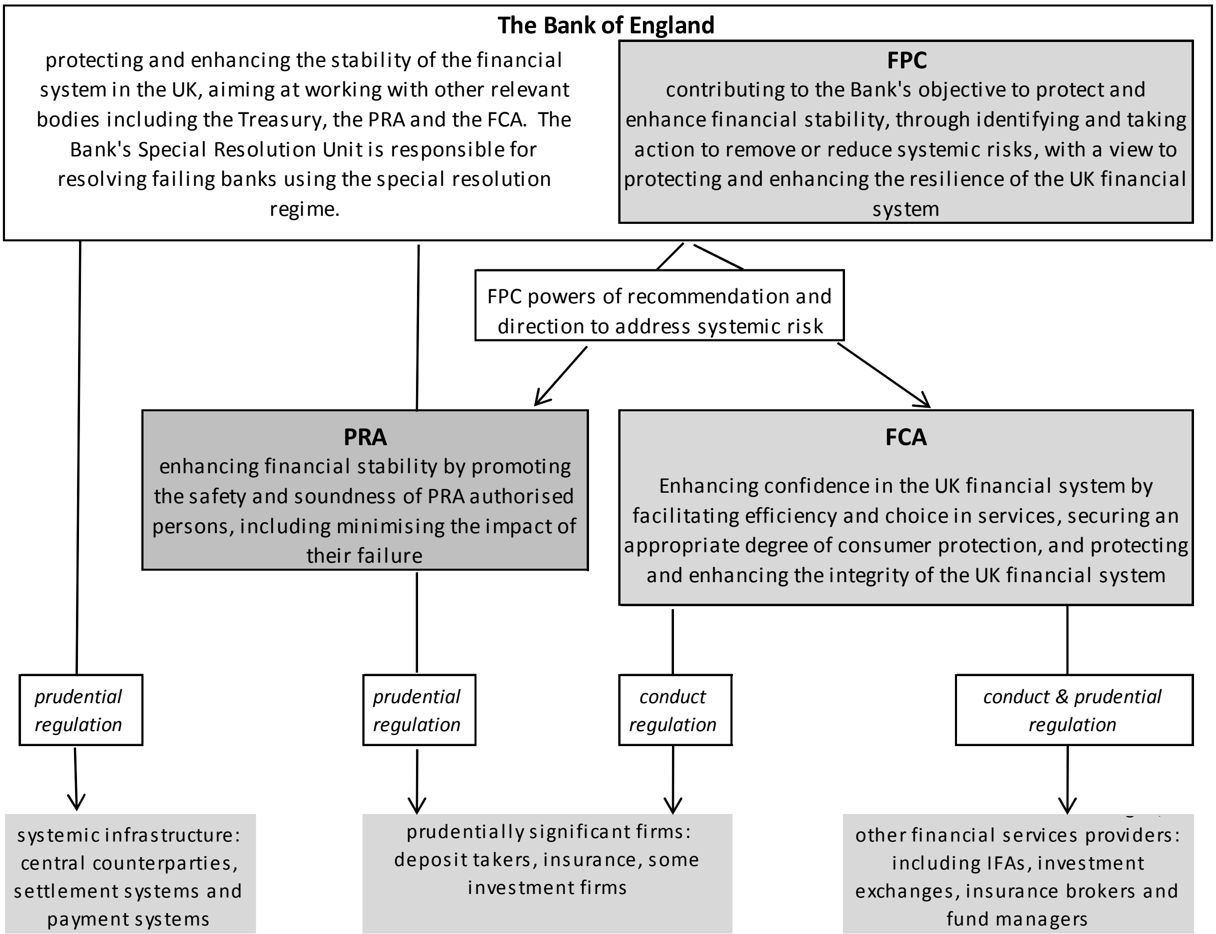
Accountability, to Parliament and government is provided by a proposed requirement that the FPC will be required to produce six-monthly Financial Stability Reports. These will go to the Chancellor and will be laid before Parliament. It is envisioned that the Treasury Committee

28 Ibid p3

29 Ibid pp4-5

will have a similar role towards the FPC as the one it already has towards the Monetary Policy Committee.

Thus, the proposed structure of regulation will look something like the following:




Key:

| | |
|---|---|
| FPC | Financial Policy Committee |
| PRA | Prudential Regulatory Authority |
| FCA | Financial Conduct Authority |

In November 2010 and in February 2011 the Government produced further consultation documents responding to the responses it had received. The February document: A new Approach to Financial Regulation: building a stronger system[30] identified the key issues that had emerged from the previous consultations:

> 1.17 The overwhelming majority of consultation respondents welcomed the proposed framework for financial regulation; most also supported the specific emphasis on promoting financial stability and the enhanced focus on macro-prudential as well as micro-prudential regulation. Alongside this general support, respondents also highlighted a number of areas for further consideration. The Government identified five key themes in its summary response:
>
> - the need for the regulatory authorities' core statutory objectives to be balanced and supplemented with other factors;

[30] Cm 8012, February 2011

- the importance of accountability and transparency for the PRA, the FCA, and the FPC;
- the need for a strong, coherent markets regulation function within the FCA, including the functions of the UK Listing Authority;
- the importance of the European and international agenda, both during the transition phase and in steady state; and
- the importance of effective coordination between the new regulatory authorities.

> A further document of interest with respect to the supervisory reforms is part of the latest FSA Business Plan.[1] As well as providing a good description of the huge amount of regulatory work that is ongoing, it discusses how the FSA is preparing for a possible post-FSA world.

The Treasury Select Committee published *Financial Regulation: a preliminary consideration of the Government's proposals* in February 2011. This covered both supervisory structure and regulatory issues. One of its key concerns was that the timetable for introducing the new rules was too rushed.

> The financial services industry is an important contributor to the United Kingdom's economy. It needs to be regulated effectively but proportionately. It should not have to deal with regulation in a state of flux, which could result if the initial reforms turn out to require further change. Urgency could be counter-productive for stability and certainty.[31]

It recommended that the Government delay introducing firm proposals before the Vickers Commission (see below) had reported in the summer 2011. Choosing to ignore this recommendation the Government published its White Paper A new approach to financial regulation: blueprint for reform in June 2011.[32]

## 5 Draft Financial Services Bill

Announcing the draft bill the Financial Secretary, Mark Hoban, said:

> It is now well known that the tripartite system set up by the last Government failed spectacularly in its mission to maintain stability. The decision to divide responsibility for assessing systemic financial risks between three institutions meant that in reality no one took responsibility. The crisis dramatically exposed this flaw and cost the taxpayer a vast amount of money. Mr Speaker, we cannot allow another crisis as the one we have just witnessed.
>
> Shortly after taking office we set in train a consultation on reforming our system of financial regulation. Today, after two extensive rounds of consultation, I am presenting to the House a White Paper, including draft legislation, setting out the blue print for a completely new system of regulation. Let me summarise the main proposals.
>
> **FPC**

31 H*Financial Regulation: a preliminary consideration of the Government's proposals*H, HC 430-2010-12, Summary

32 HA new approach to financial regulation: blueprint for reformH, June 2011, Cm 8083

A permanent Financial Policy Committee will be established inside the Bank of England. Its job will be to monitor overall risks in the financial system, identify bubbles as they develop, spot dangerous inter-connections and stop excessive levels of leverage before it is too late. It has already started operating, on an interim basis, and is having its first formal meeting today. Subject to legislative progress, the permanent body will be in place by the end of next year.

**PRA**

We will abolish the Financial Services Authority in its current form, and transfer its significant prudential functions to a new Prudential Regulatory Authority that will sit in the Bank of England. The Prudential Regulatory Authority will focus on micro-prudential regulation. It will bring judgement to the vital task of regulating the soundness of individual firms that manage risk on their balance sheet, particularly banks and insurance companies.

But we recognise, of course, that these types of firms engage in very different types of business, which is why we are proposing to provide the PRA with a specific statutory objective for its insurance responsibilities.

**FCA**

We are also bringing a new approach to protecting consumers. A new Financial Conduct Authority will oversee the conduct of financial services firms, the operation of markets and the protection of consumers, with new powers to ban the sale of toxic products. I can confirm that as an integral part of its mission to secure better outcomes for consumers and investors, this Authority will also have a new duty to promote competition. Judgement, discretion and pro-active intervention will be the hallmark of our new regulators.

**Next steps**

We are bringing forward this draft Bill for pre-legislative scrutiny, for which a Joint Committee of both Houses will be shortly be convened. We are seeking valuable input from Members on both sides of this House. It is in all our interests to get this right.

**[...]**

**Conclusion**

Mr Speaker, when the coalition government came into office questions were being asked about the future of banking and regulation, but they had not been answered. It has been our job to resolve them. Our goal should be a new settlement between our financial system and the British people. A new settlement where the banks support the people, instead of the people bailing out the banks. This statement today sets out the progress we have made towards building this new settlement and the actions we are taking to complete it. [33]

## 5.1 The draft Bill

The draft bill is split into five substantive parts. The principal features of each part are shown below:

**Part 1**: includes provisions to enable the Bank of England to take on its new role

[33] HC Deb 16 June 2011 c959

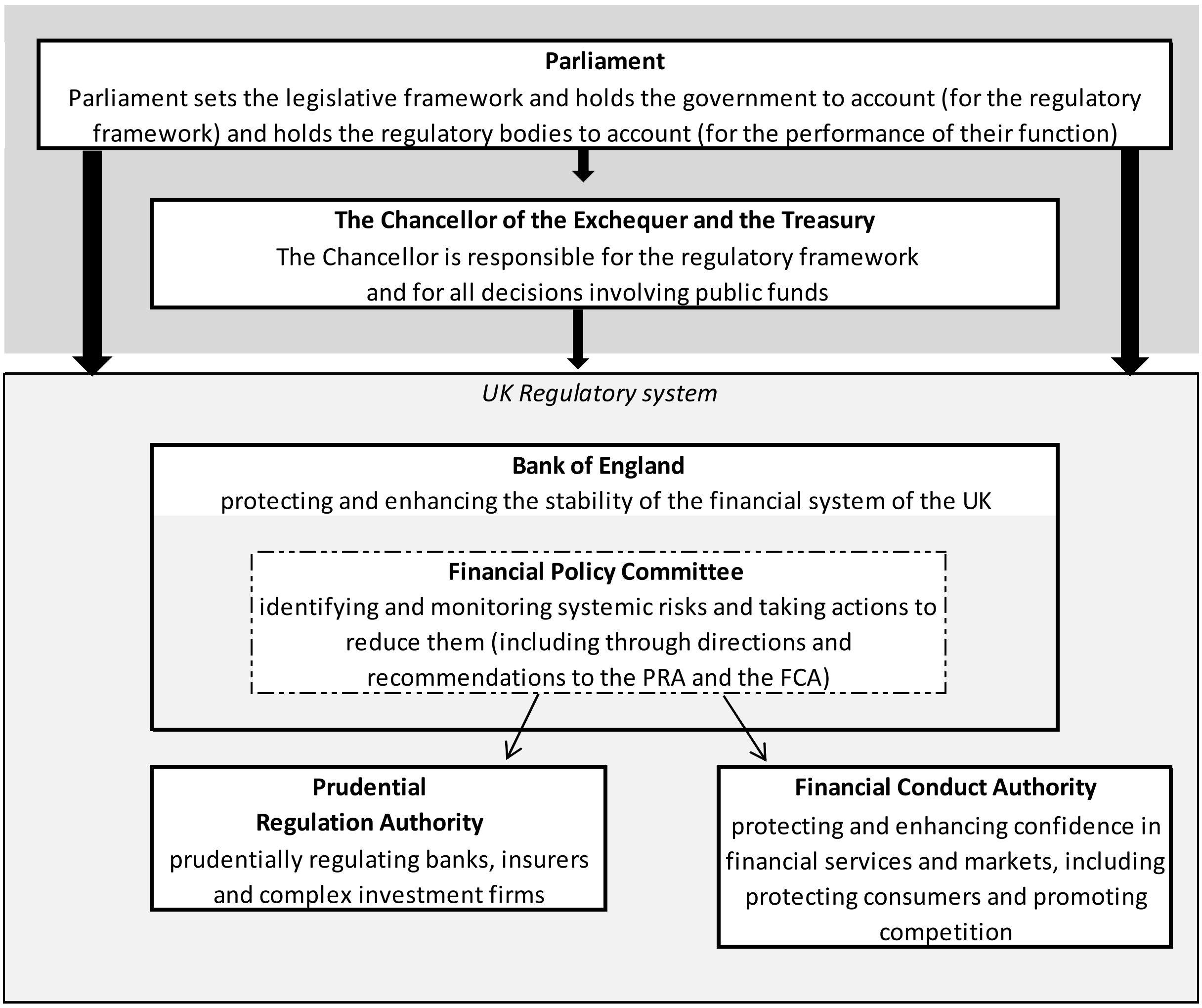
**Part 2**: establishes the new regulators – the FCA and PRA – and the consequent necessary changes to the existing Financial Services and Markets Act 2000, changes to the powers and duties of the new bodies and of the Financial Services compensation Scheme and the Financial ombudsman service

**Part 3**: sets out the memorandum of understanding and rules of conduct between the Bank of England, the Treasury and the other regulatory bodies – in essence the tripartite arrangements replacement

**Part 4**: establishes the circumstances when the Treasury or the regulator can conduct 'inquiries and investigations' into the activities of financial institutions or into cases of possible regulatory failure

**Part 5**: makes changes to the banking special resolution scheme introduced by the Banking Act 2009.

The Treasury also produced a simplified diagrammatic representation of the 'roles and accountabilities' in the new system. It is shown below:




## 5.2 Joint Committee proceedings

There were 14 evidence sessions to the joint Lords-Commons committee. Oral and written evidence can be found here. The committee's final Report can be found here.[34]

Various themes emerged prominent during the oral sessions. Some were more subject orientated than others which focussed on the details in the bill itself. Of the former type, the committee asked about:

- the danger and importance of regulatory arbitrage
- regulation culture – rules versus judgement
- an examination of whether the new arrangements would have prevented the previous crisis
- the challenge for the FSA to retain staff and resources in the transition

More directly bill - related themes include:

- the role of the FPC;
- the definition, or lack of, financial stability; and
- accountability of the Bank of England and the Governor

Of the witnesses who were asked, the majority were broadly in support of the Bill, though several had specific issues with parts of it. Despite the broad approval few were prepared to state that had the bill been in force five years ago, that it would have prevented the financial crisis. Elements of the crisis were imported from abroad and when things are going well regulators are not necessarily looking for potential trouble. Culture and experience of regulators amounts to much more in terms of practical regulation than specific structures. Regulators it would seem can fall asleep as easily in a tripartite system as they can on top of 'twin peaks'. Various quotes from the oral evidence sessions are shown below, which illustrate these comments.

The 'City' view:

> ***Mr Beales***: My name is Peter Beales. I represent AFME, which is an association established to represent, in Europe, firms active in the capital markets. [...] We feel that the legislation is a very helpful development. The focus on prudential regulation was found to be wanting in the previous regime and a major thrust of this legislation is to rebalance the focus, both by separating prudential regulation from conduct regulation but also through establishing the FPC. The Treasury are clearly listening to views expressed on the previous consultations, both from the industry and consumer side. We still think there is some more work to be done on the Bill, both in terms of the relationship with European regulators, which, from AFME's point of view, will be a rather important test of the success of this measure, but also in terms of the accountability of the regulatory bodies, some of their powers, due process and those kinds of issues which the Treasury is exploring, but we do not think they have quite reached the drafting finality that we are seeking. I think there is important work for your Committee here.
>
> **Mr Brown:** That is a very helpful answer, if I may say so. Do you want to add anything, Mr Florman?

[34] Joint Committee on the draft Financial Services Bill, HC 236 2010-12

***Mr Florman***: I would support everything that Peter has just said. I am Mark Florman, the Chief Executive of the British Venture Capital Association. The members of the association are private equity firms and venture capital firms, so we have very little to do with banking as such. I cannot really comment on financial risk and banking risk, but I think, overall, the Bill is excellent and a great improvement on the past.[35]

The Bankers view:

**Mr Laws:** If we re-ran the last decade with this policy architecture in the Bill in place, including the FPC and everything else, how does each of you think the last few years would have been different? In particular, are you at all optimistic that we would have had better policy outcomes?

***Bob Diamond (Barclays)***: You ask a very difficult question. I don't think any of us in hindsight could say clearly one way or the other. What I would say is that we are broadly supportive of this architecture. It raises issues around balance—in my mind, the issues around this are the balance of jobs, economic growth and making sure it is connected with Parliament and the Chancellor. The issues around this are balance in terms of the G20 and the EU: is it consistent with what goes on there? There are issues around governance. So much of this depends on the people and not the model. I hesitate to think that there is a model that is going to prevent something, for the reason that, under any model, it is really about the people, the culture and the governance.

**Mr Laws:** That is obviously an important point. When Sir John Gieve [Bank of England] gave evidence to us the other day, he touched on the issue whether, if we had had the architecture, we would have made the right decisions. The Barclays evidence on this particular point, on the FPC, which is, I suppose, one of the crucial elements of the Bill that could have made a difference, sounds quite sceptical on whether this would really have made a difference. In particular, the evidence that you have given says: "It is worth adding that the concepts and tools of macro-prudential regulation are largely new and untried. As it is currently proposed, the FPC will be using untested tools to achieve an undefined concept." That sounds pretty sceptical, if I may say so, as to whether you really think the FPC would do a good job in the way that, as Mr Gulliver suggested, in a more ideal world it could have done a few years ago.

***Bob Diamond***: [...]. There is no question in our response that we are supportive, very broadly. There are questions that were raised that can be refined on governance. There are questions that could be refined on the other two issues that I mentioned, but I do not recall exactly where that phraseology fits in. I think it is on the definition of financial stability. Is it? Yes, it is. We are clearly supportive.[36]

The (ex) Chancellor's view

**Chairman:** Mr Darling, [...] Perhaps I may begin by asking the very obvious question: what features of the tripartite regulatory architecture which prevailed at the time represented any particular difficulty when you were handling, first, the Northern Rock crisis and then subsequent banking rescues?

***Alistair Darling***: [...] To turn to your question, Mr Lilley, one of the things that I think is important to keep in the front of our minds is that basically you can make any regulatory structure work. At the end of the day, what is more important are the

[35] Joint Committee on the draft Financial Services Bill: Evidence 18 October 2011 Q351-2
[36] Joint Committee on the draft Financial Services Bill: Evidence 1 November 2011

individual judgments of the men and women who either regulate or, in the case of the tripartite committee, had to reach decisions in 2007 and, more acutely I suppose, in 2008.

[...] it is terribly important that as the Committee looks at the new structure what will make or break this are the individual judgments. I hope that I will have an opportunity to say something about crisis management, because perhaps a year later that came into sharper focus. I do not think the problem was so much the structure as individual judgments, although I should perhaps flag up at this stage that in a crisis the question of who actually makes the final decision as to what you do is a very real one. As I explain in the book, I became frustrated that the Bank would not put more money into the system. Only the Bank could do that, and the Treasury would have had to set up a new structure to do that. At the end of the day, I had to answer to Parliament and the country as to what was going on. So, yes, there is always a possible conflict and, as we develop the argument this afternoon, it remains in the new structure, but the big thing is the judgment of individuals.

**Chairman:** Do you think that effectively it is unavoidable whether you have a tripartite, twin peaks or single structure?

***Alistair Darling***: Once you have more than one person in the room it is a problem.[37]

## The Bank of England's view

**David Mowat:** If I may move on to Europe, we have had evidence from a number of people who have said that the principal issue in terms of regulation is not necessarily structure but people and how they exercise judgment, and all that goes with that. Therefore, within reason most structures could be made to work effectively, and yet the twin-peak structure that we are putting in place is quite different from the European structure that overrides it in terms of the sectoral versus matrix approach to it. Do you see that being a problem, or is it something we can work with?

***Sir Mervyn King***: No. The reason we want to move towards a twin-peak approach is precisely to deal with the point made in your first sentence, which is that it is a question of judgment and culture, not structure. I was in favour of the 1997 reforms, but I came to see that it proved extraordinarily difficult to enable the regulators to make judgments in the field of prudential regulation when the same people were being asked to carry out conduct of business, enforcement and consumer protection regulation, which by its nature has to be rule-based, is highly legalistic and will appear to be rather bureaucratic. It is very important to get away from that when it comes to prudential regulation.

As to prudential regulation, the reason it has become so legalistic and bureaucratic—it matters that we avoid this—is not because of the FSA but the firms themselves. Their lawyers will tell them that, provided they cannot find a specific rule that prohibits an activity, they can go ahead and do it. That stops the firms themselves thinking, "Is this taking too much risk on the balance sheet? Is it an activity in which we ought to be involved at all?" The judgments which ought to be made about the ethics, ethos and the culture of the bank itself tend to get undermined when you end up with a game in which the regulators are continuously rewriting the rules because at the same moment the firms are devising new products to get round the detailed legal rules which were in place before in order to avoid the spirit of regulation.

[37] Ibid oral evidence 11 October 2011 Q207 -208

I give two examples of where we think it will be important for regulators to exercise judgment and why we need to make a break from the style of regulation we have seen in the past. One is that I would like Andrew and his colleagues to be able to say to a bank—this is a hypothetical example but is clearly relevant to what happened before the crisis—"Your leverage has gone up from 20 to one to 40 to one in the past four or five years. You have not broken any rules. Nevertheless, this is a highly risky set of activities to undertake, and we want you to reduce your leverage." The only way that regulation can have an effect is if the regulators have the freedom to impose their judgment and not base it purely on a myriad of detailed rules.

Another example would be to say to a bank, "The structure of your bank is so complex and opaque, with so many offshore and onshore legal entities, that we don't understand the risks you are taking. We are not entirely confident that you do either, but certainly outside investments cannot assess it. We think that degree of opacity is inconsistent with a sensible and stable contribution to financial stability." These institutions are operating not only for themselves; they are big enough to affect the economy of the whole country. Therefore, the regulator has to be free to make a judgment about that degree of opacity, even though nothing is done that could be said to violate a specific detailed rule. That degree of judgment is vital. The choice is yours. If you want to stay with a highly legalistic and bureaucratic regime for regulation, which many of the institutions would prefer, please do not give it to us. We would not want to take on that responsibility. If you want judgment to be exercised, we are prepared to take it on.

**David Mowat:** For the avoidance of doubt, you don't see a conflict between the ESA structure that the Europeans are developing and the twin-peak structure that we have?

***Sir Mervyn King***: I don't think so. We are the only country in Europe to have a Financial Policy Committee which has a direct parallel at the European level in terms of the European Systemic Risk Board, so in that area we are much closer to Europe than other countries. Broadly, all countries recognise that they have different structures to deal with banking and insurance regulation. For a long time we were out of kilter with the majority in taking this away from the central bank. I don't have a particularly strong argument to say why it has to be in the central bank, but the Prime Minister and Chancellor put to me reasons why they wanted it in the central bank. After the experience of the past four years I thought they were pretty compelling reasons. It makes sense to go down the road which the Bill proposes, but the choice is yours.[38]

The Final Report from the Joint Committee concluded on this issue that:

24. To be successful the reforms will have to change the regulatory culture and philosophy. It is through a change in culture and philosophy that the relevant authorities can best ensure both financial stability and good conduct of business. A key aspect of the cultural change needed will be a shift towards forward looking supervision as explained in paras 188-198. This will require staff with appropriate experience, approach and attitudes. A change in culture is not something that legislation can guarantee but legislation can influence the culture of a regulator by:

(1) setting objectives,

(2) allocating and aligning powers and responsibilities,

(3) establishing appropriate systems of accountability.[39]

[38] Ibid Oral evidence 3 November 2011, Q 767
[39] Joint Committee on the draft Financial Services Bill, HC 236 2010-12, pp24

Of all the specific bill details, the one commented on most frequently was the role and accountability of the Financial Policy Committee (FPC) which, under the bill will have an overarching responsibility for identifying and reducing systemic risks. To use an old central bankers joke, it is the FPC which is in charge of the 'punch bowl'. Extracts from the oral evidence on the role of the FPC are shown below:

The consumer watchdogs' view:

> ***Christine Farnish***: I would be very happy to kick off, if I may. Obviously, it is very important we strengthen and seek to improve the UK's regulatory regime in the wake of the recent crisis. The danger will be that we lurch too far in one direction in pursuit of a single objective. As we all know, the world is a lot more complicated than that. We have quite serious concerns about the fact that very significant powers are being given to the new Bank of England group. The FPC will be able to direct the new regulatory bodies, both the PRA and the FCA. The PRA will have a veto over the FCA. We do not think the balance is right yet in this draft bill; it is too one-sided. If you go too far in terms of financial stability obviously you will not deliver what is required for both the UK consumers and businesses in this country. It is a balancing act, and we think the strategic objectives are not yet sufficiently balanced.
>
> **Chairman:** Is that a general view?
>
> ***Martin Lewis***: When I went through it I had to read it again and again until I started to understand how the system began to work. Even once I started to understand what the FPC, PRA and FCA did—frankly, there are more acronyms than the driving licence authority—I realised that it did not include competition and credit, which are what people think finance is about—making sure it is competitive and there is credit out there. [...] When you look at where consumers are in this—it is the third body that cannot look at competition and does not really deal with credit, which is what I tend to have most problems with because debt is really what it is all about. Then you may have some consumer representation on the consumer panel, but the other two big and important bodies do not. Therefore, when a decision is made that we need to curtail the amount of lending done by the FPC because it is impacting the economy, and suddenly realise that effectively you trap people in their existing high-rate mortgages so they cannot remortgage and leave them stuck at that level, we have a real problem about the limited extent to which consumers are being thought about in the system. More importantly, we cannot have faith in a system we do not understand.[40]

The ex- Chancellor's view:

> ***Alistair Darling***: The FPC is a good thing. I am pretty sure I suggested something similar in one of my Mansion House speeches [...]. I am bound to say that it was not developed to anything like this extent. On the other hand, as the Government's own paper here notes, it is novel in that nobody actually knows how to do this. It is all very well to say we should have a mechanism that allows you to lean against the wind. There are lots of distinguished papers on all this stuff, but nobody knows how you do this in practice. You have a committee which, incidentally, from the point of view of the Bank is far too top-heavy; it has six Bank members and four outsiders. That just won't wash. I do not understand why it has been farmed out as a subsidiary of the Court.
>
> Its other flaw is that it can make recommendations to just about everyone under the sun except the Bank. Who controls monetary policy? It is the MPC. You can tell the

[40] Joint Committee on the draft Financial Services Bill: Evidence 15 September 2011,Q119-120

Treasury that its fiscal policy is no good; you can tell the Chancellor that his policies are wrong. Naturally, you can, fair enough, tell the regulator or issue instructions, but it seems rather lop-sided. It has all the hallmarks of things being bolted on. The Government will be pleased to know that I have no direct knowledge of this, but this looks like the result of negotiation of the sort I recall all too well.[41]

The 'City' view:

**Mr Laws:** On the FPC and its objectives, obviously some people have criticised the definition of the objective and whether it is clear enough. Barclays in their submission to this Inquiry commented to us: "As it is currently proposed, the FPC will be using untested tools to achieve an undefined concept", in terms of the objective. Do you have any sympathy with that view?

***Mr Florman***: We are not in the banking business, but I know that there is an impact for private equity because we need to work closely with banks. The counter to macro-prudential supervision and overall systemic risk oversight is to ensure that the industry functions, works and continues to lend money. The overall objective has been proposed to maintain a sustainable supply of credit. That is also a very valid thought to make sure that banks continue to behave, to lend and to be part of industry. There are almost two aspects, and, if we go overboard in regulation in all aspects of financial services, we can find that we create an effect that we did not anticipate.

***Mr Beales***: We feel that elements of the Bill should be amended to require the FPC to explain how it envisages using the tools and there should be a reporting mechanism so that when a tool is applied there is a method of assessing how that works in practice, both good and bad effects. More can be done—not to circumscribe what it does but to make what it does explicable and capable of being judged.

**Mr Laws:** Are you content with the way the objective is defined at the moment?

***Mr Beales***: Given that the nature of macro-prudential regulation is still being explored, this is going to be a definition that we have to revisit in any case. Hopefully, the international consensus will be emerging sufficiently for us to know whether the Bill fits with it when this is debated formally.[42]

The academics' view:

**Mr Laws:** The other issue mentioned earlier by the former Chancellor was accountability of the FPC potentially to the political world. You have mentioned the Treasury Select Committee which has quite a lot of work to do and is already reasonably stretched. Are you satisfied that the political accountability of the FPC as it will be set up under the Bill is going to be effective enough both in crisis and non-crisis situations?

***Professor Goodhart***: In non-crisis situations, the argument for the independence of the FPC is the same as the argument for the independence of the MPC, which is that the regulation has its major effect during the upswing. If you are in a crisis and everyone is in panic, the market constrains you and your risk aversion is so much greater that the regulators are now trying to find ways to reduce the ratios but hope that it will not appear to be too odd at a time when banks are obviously in difficulties. The real time when financial regulation can affect the system is when it is in a strong upswing. The problem with that is that a strong upswing is enormously popular because everyone is getting richer and tax revenues are coming into the system.

[41] Ibid , 11 October 2011, Q212
[42] Ibid ; 18 October 2011, Q362-3

Everyone thinks that it is all right; the lenders love it and the borrowers love it. Borrowers and politicians loved subprime. It was quite largely the politicians who pushed Fannie Mae and Freddie Mac into doing more of this. The difficulty is that, if you are faced with a housing price bubble and one of the possibilities you may want to undertake is to raise capital requirements on banks lending on housing, or tighten up loan-to-value ratios, it will be enormously unpopular politically. To leave the politician with the problem of having to take action which will be extremely unpopular politically, even if necessary, will be quite hard.

**Mr Laws:** Do you think that perversely that might justify people seeing a greater degree of political accountability, in the sense that this committee might be taking even more difficult judgments than the MPC, if that is possible? Therefore, when the unpopular decisions you are describing are made, people might well say, "We can't get mortgages and buy houses. Who are these people who are squashing the economy for no good reason?

***Professor Goodhart***: It is a judgment you can make. I know that my colleague Willem Buiter, who I always enjoy listening to, very much takes the opposite line. He uses as his model the Financial Supervision Oversight Council in the USA which is chaired by the Secretary of the Treasury. He thinks that that is a better framework. You can argue this either way. I understand the line of argument which says that leaving everything to the independent judgment effectively of the Bank of England is undemocratic. I have been doing a study of Swedish monetary policy along these lines. There are very considerable questions about whether Sweden will want to put all responsibility for macro-prudential control into the Riksbank. The question is where you place the macro-prudential control: do you place it with the central bank or the FSA or the micro-prudential authority? It is a delicate issue. I do not think it would be proper to say there is necessarily a right or wrong answer.

***Professor Kay***: One should think of these political implications in a fundamental way. I hope that one of the things you will be doing is to ask the people who are before you what would have happened, and how things would have been different, in relation to some of the events which happened in the years leading up to 2007. That is true in relation to both the FPC and PRA. Would the attempts by both Barclays and RBS to take over ABN AMRO have been blocked? As the former Chancellor seemed to imply when he talked to you earlier, would you have raised capital requirements in response to that? If you had done that, is that intended to be a way of saying no, or is it a sort of fine for having done something that is not considered wise? What would these two agencies have done in respect of mortgage lending in the UK and to restrict Northern Rock?

**Mr Laws:** You have to give us your conclusion of this. Are you optimistic that they would have made a difference?

***Professor Kay***: My belief is that it is unlikely they would, but, as Charles has said, there is no political constituency at all for taking these forms of actions. The bankers that we are attempting to regulate are against it; the public will be against it; the press will, quite reasonably, be asking why you are depriving us of our cheap mortgages, etc., and our higher deposit rates when it comes to Kaupthing and Landsbanki, which is an even more interesting case of regulatory failure.[43]

The bankers' view:

[43] Ibid ; 11 October 2011, Q263-265

**Chairman:** I open the questioning by raising an issue that at least two of you have put in your written submissions to us, which is that the current objective of the Financial Policy Committee as laid out in the Bill to focus on financial stability is ill-defined and might be better replaced by something on the lines of: "In relation to financial [stability] policy, the objectives of the Bank of England shall be (a) to maintain a sustainable supply of credit, and (b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment", thereby, particularly in the latter respect, bringing it much more into line with the objectives of the Monetary Policy Committee.

[...] Do you think there is any potential for conflict between the policies of the Financial Policy Committee and those of the Monetary Policy Committee, between one trying to affect stability and, in your view, the supply of credit, and the other affecting interest rates, inflation and the price of credit? Do you think they are ever potentially in conflict?

***Stuart Gulliver***: I guess that is our concern. The way we would see it is that the Monetary Policy Committee is clearly affecting the price of credit into the system—that is the price of money. Therefore, we were expecting that the Financial Policy Committee would be looking at the supply of credit into the system. You would have two mechanisms, one of which deals with inflation and setting interest rates, and the other with how you can ensure macro-prudential tools are used to cool the economy when it is overheating, and indeed support it when it is cooling down. Tools that are used regularly, for example, in Asia Pacific, are adjusting cash reserve ratios and loan-to-value ratios on mortgages—these types of fine-tuning tools.

The way the FPC has been set up is that it is focused entirely on stability. You could have a situation where the economy is stable, i.e. all the financial institutions are very conservatively capitalised and so on, but there is actually no lending going into the economy. You could see a situation where everything has been secured to such an extent that there is no risk of a failure but there is no credit going into the economy either. We had expected there almost to be a symmetry between these two—the left and the right arm, which is the MPC and FPC. One is going to the price and one is going to the supply. That is why we are a bit concerned about the definition, because there is not that symmetrical approach now, so one could contradict the other.

**Chairman:** Would that suggest that there might even be an advantage in simply merging the two committees?

***Stuart Gulliver***: [No]... It would, therefore, be important for the FPC to have the same goals that the MPC has, which is that the UK Treasury should be setting out what the Government's goals are for growth, employment and job creation and saying to the FPC, "Use your macro-prudential tools to ensure that you achieve the Treasury's goals." That needs to be brought out a bit more in this legislation because what it says is, "Create stability," when stability may not be consistent with the goals of the Government, to create economic growth and jobs. But I would not go as far as to suggest that they should be combined. They are different disciplines, although there will clearly be a common set of people at the umbrella level.

**Chairman:** Would others agree or disagree?

***Bob Diamond***: We support it. It was HSBC who first brought up the concept of sustainable credit into the market, and we supported that. Our take on it was similar.

***Stuart Gulliver***: The other thing we would seek to see is almost a parallel structure in how the FPC seeks to change things, meaning that, if there is a departure from or an addition to the macro-prudential tools and they are going to be examined, it will be dealt with by a letter to the Chancellor, copied to the Chairman of the Treasury Select

Committee, so that there is that kind of openness, just as there is about missing inflation targets and so on. You would, in essence, have a parallel structure for these two committees.[44]

The Bank of England view:

**Baroness Wheatcroft:** It is a big responsibility, as you said at the beginning. Perhaps I may ask you about the overwhelming responsibility for financial stability that you are taking on. The Bank has always had a financial stability objective. Are you confident that as a group we are clear what financial stability actually is? Opinions seem to differ. Would it help if there were firmer objectives as to what financial stability might be?

***Sir Mervyn King***: Let me say what I think broadly financial stability is and why I don't think that a precise definition is something on which we should pin every hope. Financial stability is about ensuring the financial system can play its role in three areas: the payments system, so that people can make payments all the time; the transfer of savings into investment, providing savings vehicles that can be used to finance corporate investment; and the allocation of risk in the economy towards those who are most willing to bear it. That is the social role that all financial markets play.

The reason I was unhappy about the Bank's financial stability role before the crisis was that, although no one could define financial stability terribly clearly, what mattered more to me was that we had no tools to do anything about it other than write financial stability reports. What matters in terms of holding the FPC accountable is that you in Parliament will decide what instruments we will have. They could be counter-cyclical capital requirements; some people think they could be loan-to-value ratios. There has to be a public debate about this, and you in Parliament will decide what instruments we will use. They will be delegated to us and you should hold us accountable for the use of those instruments and the commentary of the FPC in the financial stability report. For the first time we will have some instruments we can exercise, and the main focus of accountability should be to say, "Why did you change or not change those capital requirements?" and, "Explain yourself in terms of the instruments we gave you to use."[45]

The Government view:

**Mr Laws:** [...] When Lord Turner was giving evidence the other day—I do not know whether you have seen all of his evidence—he was pretty supportive in this area. But he picked out a number of things that he would have wanted to do if he could have replayed 2003 to 2007 again. Some of them sound sensible and pretty uncontroversial. One of them was, essentially, to burst the property price bubble to avoid it getting out of control rather than relying upon the interest rate by controlling the amount of mortgage lending—the loan-to-value ratios which you have just mentioned. That sounds very sensible, but it would also be extremely sensitive for many of our constituents, who might find it more difficult to get the credit they need and might also question some of the people who are making those types of decisions.

Without asking you to pre-empt the process of consideration that you and the FPC are currently going through, are you looking at any ways of trying to control, limit or improve the amount of public accountability in these areas which are going to be very sensitive?

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[44] Ibid; 1 November 2011, Q692-3
[45] Ibid 3 November 2011, Q788

> ***Mr Osborne***: First of all, I would hope that this is an area that your Committee would take an interest in and advise on. It is a classic dilemma. On the one hand, we want to maintain democratic control and oversight for accountability. On the other hand, the whole purpose of this area of policy making is that you do not get politicians, who are vulnerable to the temptation of trying to win a general election, taking the punchbowl away when the party is really getting going, in the housing market, for example. In monetary policy we have found a good set of arrangements, where the Chancellor of the elected Government is accountable to Parliament. He sets the inflation target, and then the Monetary Policy Committee is independent in meeting that target. The Bank Governor is accountable to the Select Committee and others for his Committee's success in meeting that target. We have found a good balance.
>
> This is more difficult [with respect to the FPC] partly because, [...] there are not such straightforward metrics as inflation targets, or certainly none that I am aware of at the moment. You have to get that balance right between giving them the tool and then giving them the operational independence to deploy the tool, even when it may be very politically inconvenient to the Government of the day. That is the challenge. [...] But we have to think long and hard before suggesting that Parliament could override the use of the tool. Maybe that is something we should think about, but it would come with a downside. There was a temptation in 2005 or 2006—and this would be true potentially of any Government, not just the Government that was in office at the time—to keep the housing market going and find good excuses for why this was a long-term trend rather than a bubble.[46]

The Joint Committee's Report includes several conclusions and recommendations regarding the FPC:

> 32. The drafting in Bank of England Act new clause 9C which requires the FPC to pay attention to systemic risks including "unsustainable levels of leverage, debt or credit growth" goes on to define debt and credit growth as "debt owed by" and "lending to" "individuals in the United Kingdom and businesses carried on in the United Kingdom". We cannot see why this limit to the United Kingdom is specified. British banks faced in 2007, and could again face systemic risks as a result of lending to, or debts owed by, individuals, businesses or, indeed, governments abroad. As drafted it would appear to exclude US sub-prime lending or Greek and Italian bonds from the categories of credit and debt which the FPC is required to monitor. It is true that the clause does not prevent the FPC looking beyond UK lending and debt but it does require the FPC to start with this narrow focus. This adds to the impression that the draft Bill has been written initially as if it applied only to the UK with at best a belated recognition that banking is a global industry. **We recommend the Government reconsider the drafting of clause 3 (new Bank of England Act 1998 clause 9C(6)) to make clear the importance of monitoring the global exposure of UK banks.**
>
> 33. Before and during the 2007 crisis regulators underestimated risks that were building up. These risks were sometimes greater than the sum of their parts due to interconnectedness between firms but this was not properly understood or monitored. In order to achieve financial stability the FPC must carefully consider the interconnected nature of the system. **The reference in the FPC's objective to monitoring "systemic risks attributable to structural features of financial markets or to the distribution of risk within the financial sector" is presumably intended to place a duty on the FPC to consider the interconnected nature of the market—this duty should be made more explicit.** An interim FPC has already been

46 Ibid 8 November 2011, Q1018

established and we were pleased to see that at its meeting on 16 June 2011 it observed that there are "vulnerabilities relating to the structure of the financial system itself. In particular, these related to interconnectedness in the financial system and to complex or opaque instrument structures with the potential to amplify or propagate any stresses that emerged".[18]

40. **Preventing excessive or inadequate growth of credit will be an important part of the way that the FPC meets its objective. However, it will also need flexibility to consider other factors which bear on the stability of the financial system. Moreover, it would in our view be premature to attempt to set quantitative targets for credit growth before the FPC has experience of developing and applying macro-prudential tools. So we do not recommend setting a credit based objective for the FPC.**

44**. The Government is right to require the FPC to consider the impact of its decisions on growth. But the Bill's current drafting is too strong and restrictive. The FPC is not authorised to take any actions to promote stability if it is likely to have a significant adverse effect on the financial sector's contribution to growth in the medium or long term. The Bill should be redrafted so that like the MPC, the FPC must have regard to the Government's growth and other economic objectives subject to meeting its primary responsibility of attaining financial stability.**

49. We would address concerns about accountability of the FPC in two ways. We support the proposal of the Treasury Select Committee for the replacement of the Court of the Bank of England by a supervisory board to oversee the work of the Bank, and of the MPC and the FPC (see para 309). But while the supervisory board can provide independent assessment and review of the performance of the Bank, it cannot provide political oversight; that has to be exercised by either the executive or by Parliament. Therefore, in order to provide effective political accountability, **the draft Bill should be amended so that the Treasury, not the FPC, has the final say about the interpretation of the remit of the FPC. We would normally expect the Treasury and the FPC to come to an agreement about the remit and therefore we would not expect the Treasury to have to override the FPC on a regular basis. If the FPC has any objections to the annual remit issued by the Treasury it should make these public and alert the House of Commons Treasury Committee. Notwithstanding that the Treasury may have suggested matters that the FPC should regard as relevant to the Committee's understanding of the Bank's financial stability objective the Bank of England remains responsible for the entirety of that objective.**[47]

The other issue touched on at length during the evidence sessions was the role, governance and accountability of the Bank of England.

The Consumer organisations' view:

**Baroness Wheatcroft:** Are you uncomfortable with it all being taken under the wing of the Bank of England and with the governance of the Bank of England itself?

***Christine Farnish***: Perhaps I may comment on the question raised by Baroness Wheatcroft about the Bank of England, which is a very important issue. The Bank of England group going forward will have an unprecedented suite of powers. It will be responsible for monetary policy, financial stability, what is known in the jargon as

[47] Joint Committee on the draft Financial Services Bill, HC 236 2010-12, pp14-17

macro-prudential regulation and micro-prudential regulation, which we have just been talking about. It will have the function of lender of last resort and the provision of liquidity to the financial system; and it will be overseer and regulator of the payments systems. In addition, it will be a special resolution authority if a major institution goes belly up. That is an enormous suite of very wide and significant powers which potentially will have a huge impact on everyone's daily lives, the availability of credit, the way in which the financial system is working and the economic welfare of this country. To us it is very surprising that that suite of powers is being granted to a body that has no formal accountability to Parliament or the general public. There is a lot of work to do in the way in which the accountability and governance arrangements in this Bill are formulated to strengthen those arrangements.[48]

Sir John Gieve (Deputy Governor of the Bank of England during the crisis)

**Lord Newby:** Do you think he [the governor] is being given too much power under the new regime?

***Sir John Gieve***: All of that is a very heavy burden, especially when you add in that he is chair of the Basel Committee, deputy chair of the European System of Central Banks and is on the G7, G20 and so on. His life could be one long series of committee meetings. On the whole, it does put too much weight on one person's shoulders and it would be good, assuming the Bank will have these new responsibilities, to delegate up or down a bit.

**Lord Newby: [...]** if you had to reduce it in any respect which do you think it would be most appropriate for him not to do, as it were?

***Sir John Gieve***: Within the structure that has been set up, the obvious thing is to give one of his Deputy Governors a proper job and make them chair of something. The PRA would be the obvious one. That is a bit awkward because you have a Deputy Governor who will be chief executive, and so on. None the less, I would delegate that. The Governor's role is very odd. Mostly, we move to a chairman and chief executive arrangement and in this case we have not. We have an executive chairman except in the Court, and the relationship between the chair of the Court and the Governor is not the normal chairman and chief executive relationship. Within the structure we have got one obvious thing to do would be to make Paul Tucker chair of the PRA.[49]

On the question often asked during the post-crisis investigation – who's in charge...

***Sir John Gieve***: In terms of financial stability and taking actions to prevent the breakdown of stability, it is very clear who is in charge: the Governor is in charge and he is responsible. That is a change. There is not a question of whether responsibility is with the FSA or the Bank; it is now definitely the Bank. Ambiguity may arise if there is a crisis. Is the Chancellor in charge or not? I have not studied the Bill at huge length on this, but there seems to be a trigger mechanism in which the Bank informs the Chancellor of a potential risk to public funds. In practice, at that point the Chancellor takes over. Throughout the process from 2007 to 2011 the Chancellor chaired the meetings and set the agenda, but Alistair said afterwards that he found it very frustrating, that we were very difficult to deal with, et cetera. I can understand that. The only question is whether the Bill needs to give some recognition of that. I do not think it

[48] Joint Committee on the draft Financial Services Bill: Evidence 15 September 2011,Q123
[49] Ibid 27 October 2011,Q653-5

should go to the point of transferring all the Bank's and FCA's legal powers to the Chancellor at a trigger point, but it would be sensible to have some recognition that in a crisis where the taxpayer is at risk there is a duty for the Bank and FCA to co-operate under the chairmanship of the Chancellor.[50]

The Bank of England view:

**Mr Mudie: [...]** In the proposed changes, there is a view that too much power, but above all responsibility, is being placed on your individual shoulders—[...] Are you quite adamant that the holder of the post can chair and participate in various international and national regulatory matters? If there is a view that changes would have to be made because it is too much to put on someone's shoulders, do you have a view on what changes should be in the field for consideration?

***Sir Mervyn King***: Yes, I do. I certainly don't want to be adamant on anything. It is already a big job and, to be honest, it has changed in the last three years. We are already in a position where I have to spend a lot of time on monetary policy, the Financial Policy Committee and the PRA—we are spending a lot of time on designing and constructing the PRA—plus the international commitments. How am I coping with this, and what are we doing in terms of the post? Before the crisis, I chaired all the minutes meetings of the Monetary Policy Committee, where we drafted the minutes. That I delegated to Charlie Bean, so I do not chair all the meetings of the MPC that I did before. On the Financial Policy Committee, the driving of the work is the responsibility of Paul Tucker, and he chairs the Bank's Financial Stability Committee, not me. In terms of the PRA, most of the work is done by Hector Sants and Andrew Bailey, and the Governor will be involved only in a question about a major institution.

I say two things in conclusion. First, I am convinced that if there were to be a major problem in any of these areas and these responsibilities were in the Bank of England you would want to call the Governor of the Bank of England before the Treasury Select Committee and ask what went wrong. I don't think you can do that unless the Governor is chairing those bodies. I would draw a distinction between chairing the bodies and the amount of time involved. It is not just an additive thing. Most central banks are involved in these things. We would be returning to a more conventional central bank portfolio. The reason my view has changed since 1997 is that my experience of the crisis has led me to believe that when you have a financial crisis like this the central bank is inevitably and inextricably involved with the liquidity and capital position of banks, macro-prudential measures and monetary policy. You have to construct a mechanism by which a lot of the activities that the Governor was doing before 2007 are now delegated to the Deputy Governors, of which there will be three. This year one of the major strategic objectives in the Bank of England is to tell the whole of the Bank that each level will be delegating more authority down, because we have to do that for the Bank to function.

Secondly, if you are not persuaded by that argument, the right thing to do would be to take a responsibility away from the Bank of England completely, not try to pretend that you can have—

**Mr Mudie:** For example?

***Sir Mervyn King***: The only one you could conceivably take away that would make sense would be the PRA. The FPC and macro-prudential is inextricably linked with the sort of issues that central banks are bound up with. If your opinion is that it is too much, then the PRA is the body you should take away from the Bank of England. I would

[50] Ibid 27 October 2011, Q680

recommend that it should then be a separate stand-alone body, but if you would like the Bank of England to do it, it is manageable, provided it is understood that the Governor will delegate many of the responsibilities he was doing before.[51]

The Joint Committee's view:

**Governance of the Bank**

307. The governance structures within the Bank of England have recently been the subject of a detailed report by the House of Commons Treasury Committee.[241] That committee concluded that the role of the Court of the Bank of England needed to be substantially enhanced. It suggested replacing the Court with a new smaller supervisory board with expert members. The new Board would have new responsibilities including conducting ex-post reviews of the Bank's performance in the prudential and monetary fields. The Board would have the responsibilities that the draft Bill gives the Court for setting the Bank's financial stability strategy. It would have sight of all the papers considered by the MPC and FPC and the Chairman of the Board would observe MPC and FPC meetings.

308. The Treasury Committee recommended that the new Board would be responsible for responding to requests for information by Parliament and that it should take a more open approach than the Court.

**309. The evidence we received in the course of our inquiry indicated that the House of Commons Treasury Committee was right to conclude that the governance structures within the Bank need considerable strengthening. Our recommendations about the role of the FPC add weight to this. We support the idea that the Court should be replaced by a Supervisory Board with expert members some of whom should have experience in prudential policy. The new Supervisory Board would be empowered to scrutinise work of its sub-committees and conduct retrospective reviews of decisions taken by the FPC. The reforms in the draft Bill give the Bank significant new powers in macro- and micro- prudential policy. These powers must be paired with reforms to ensure that clear accountability processes are in place. In addition we recommend that the Chairman of the Supervisory Board should be consulted over the appointment of the Governor.**

**Scrutiny of macro-prudential tools**

310. The FPC will be given its key instruments, the macro-prudential tools, in secondary legislation. The FPC's toolkit will be largely untested. Some of the tools being considered will put considerable new burdens on banks and other firms. Some may be different from the tools being deployed in other countries. It is of utmost importance that Parliament has a proper chance to consider the impact of each tool in some detail before a decision is made about whether to grant the tool to the FPC.

311. Normally, Parliament will be asked to grant each macro-prudential tool through approval of a draft affirmative instrument or, in urgent cases, the 28-day "made affirmative" procedure. The made affirmative procedure involves less parliamentary control. The tool could be used the day it is laid before Parliament and therefore before any scrutiny has taken place. If however approval does not follow within 28 days of the instrument being laid, it would be withdrawn. The Government views the made affirmative procedure as a last resort believing it will "rarely—if ever—need to be used".[242]

[51] Joint Committee on the draft Financial Services Bill: Evidence 3 november 2011,Q778-9

312. The Treasury Committee noted that approval of draft affirmative instruments in the House of Commons would normally only require a 90-minute debate in a General Committee and a decision without a debate in the House. It recommended that it should have sight of the text of draft orders two months before they are laid in order to report to the House of Commons in time to inform debate. It also recommended a requirement that debates on orders prescribing macro-prudential measures be held on the floor of the House of Commons, free of the 90-minute restriction.[243]

313. We agree that there should be a system of enhanced parliamentary scrutiny of these important tools. This should apply in both Houses. In para 217 we recommended an enhanced procedure for scrutinising the statutory instruments that will define the PRA's regulatory perimeter. This procedure was based on section 11 of the Public Bodies Act 2011. This would provide for consideration by the relevant select committees in both Houses and where appropriate would place a duty on the Treasury to consider those committees' recommendations before laying the final instrument.

314. We are attracted to a similar procedure for the statutory instruments containing macro-prudential tools. The role given to designated committees of both Houses would allow the Treasury Committee and the appropriate committee in the Lords to bring expertise to bear and trigger the enhanced procedure only if necessary. The enhanced procedure would place a duty on the Minister to consider the reports of each committee and make material changes to the Order if those reports persuade him change is necessary.

**315. The macro-prudential tools to be used by the FPC are of considerable importance. Some of the tools being considered will have a direct effect on the economic circumstances of constituents. Parliament must have an opportunity properly to scrutinise these powers. On the other hand there must be flexibility to grant the FPC new tools quickly in rare and urgent circumstances. In non-urgent cases we recommend that the tools be subject to an enhanced affirmative procedure similar to that set out in Section 11 of the Public Bodies Act 2011. This would provide for consideration by the relevant select committees in both Houses and where appropriate would place a duty on the Treasury to consider those committees' recommendations before laying the final instrument.**

## 6 Other Reports and documents

There have been a number of Treasury Committee Reports into matters that are within the Vickers' remit, two in particular:

*Competition and Choice in retail banking;* Treasury Committee Ninth Report 2010–12, HC 612, April 2011.

The Report found that the British banking system was not very competitive, a fact worsened by the forced consolidations due to the credit crisis. It saw measures to promote competition, especially, promoting new entrants as being the key to improving the position. It drew attention to the short term versus long term interests of the divestment of national bank shareholdings. In the short term sales of shares into an unreformed market might bring a greater financial yield; however, in the longer term, a more dynamic and competitive market might raise GDP growth rates.

*Too Important to Fail - Too Important to Ignore*; Treasury Committee Ninth Report 2009–10, HC 261, March 2010

The summary from this Report sets out the issues behind this key policy area:

> This Report looks at the range of reforms currently under consideration, and assesses them against the objectives of an orderly banking system such as protecting the consumer, protecting the taxpayer, setting an appropriate cost of doing business and providing lending to the economy. There are trade-offs between these objectives: the more consumers are protected, the more risks tax payers may have to bear; the more banks have to pay for their capital, the higher the rates they will charge their customers. Policymakers will have to decide where the trade-offs should properly be made and how this should be explained to the public who understandably want to see rapid and sustainable change.
>
> Successful reform would transfer risk away from Government and back into the banking sector. We are clear that radical reform is necessary but it cannot be achieved immediately: if it were done too quickly the cost to banks and to their customers would increase too quickly to be absorbed. But it has to be done. The collapse of Lehman Brothers showed that the failure of an interconnected systemically important international firm has widespread and cataclysmic implications. An indication of improvement will be a system which enables a large international institution to go bankrupt smoothly—and where prices in financial markets do not implicitly or explicitly assume a government guarantee.[52]

The section of the Report on 'Structural Reform' goes to the heart of the issue about whether big, diversified banks are better than narrow, functionally separate banks.

> 90. Mr Corrigan [Managing Director, Goldman Sachs Bank USA] told us that:
>
> it is a little hard for me to envision a world in which we did not have financial institutions of size and financial institutions that have large amounts of capital to commit to the market place. If you look at one of the examples I use in the statement, it is in the aftermath of the crisis we had a situation in which private partners, thank goodness,

[52] H*Too Important to Fail - Too Important to Ignore*H; Treasury Committee Ninth Report 2009–10, HC 261, March 2010

had been able to raise something in excess of half a trillion dollars in fresh capital for banking institutions. The amount of risk that a small number of institutions had to be willing to 'fess up to accomplish that is very large. It is a little hard for me to see how that would happen if we had a world of just narrow banks.[101]

Mr Varley [Chief Executive, Barclays] was also keen to point out that:

The fundamental point I am making is that investment banking is real economy work. What is it that Barclays Capital does? It offers risk management and financing products to those it serves. Who is on the list of those it serves? The British Government, the French Government, the South African Government, John Lewis, Network Rail and Harvard University. These are real economy players. This is not some activity that takes place in the corner of a room which you might designate as proprietary trading; this is risk management work and it is financing work that lies at the heart of industry and governments to create employment. That is why it is important that these businesses exist within a universal bank.[102]

91. However, not all the witnesses were as sure of the benefits of large banks. Professor Kay provided the following commentary:

a large part of the synergies which we are talking about in these global banks are to do with tax, regulatory arbitrage and the kind of cross-subsidy we were talking about earlier, so from a public policy point of view we should not have very much sympathy with these synergies—the difference between the structure of HSBC and Barclays that you were describing is a lot more noticeable to Barclays than it is to the customers of either of these two banks. Going on from that, if one talks of other industries, people are endlessly talking in these industries about the desire of large corporations to buy from a single global supplier. I have heard that every year in telecoms, for example, since telecom privatisation began. Most of the evidence is that most of their customers do not: they want to pick and choose who are the best suppliers for particular goods. There are some synergies of that kind, but I do not think we should go overboard about that.[103]

The Governor of the Bank of England stated that: "I do think that I would like to see an outcome in which the size and variety of activities contained within these big institutions, if they are going to be financed in the way they are, is a lot less. To have a small number of big institutions dominating world banking is not a healthy position to be in, and I think the implicit subsidy is in part responsible for that".[104] And Mr Haldane has questioned whether large banks are a necessity:

[ ... ] the economics of banking do not suggest that bigger need be better. Indeed, if large-scale processing of loans risks economising on the collection of information, there might even be diseconomies of scale in banking. The present crisis provides a case study. The desire to make loans a tradable commodity led to a loss of information, as transactions replaced relationships and quantity trumped quality. Within the space of a decade, banks went from monogamy to speed-dating. Evidence from a range of countries paints a revealing picture. There is not a scrap of evidence of economies of scale or scope in banking—of bigger or broader being better— beyond a low size threshold. At least during this crisis, big banks have if anything been found to be less stable than their smaller counterparts, requiring on average larger-scale support. It could be argued that big business needs big banks to supply their needs. But this is not an argument that big businesses themselves endorse, at least according to a recent survey by the Association of Corporate Treasurers.[105]

Or, as Mr Corrigan conceded, although "It is a little hard for me to see how that [recapitalisation] would happen if we had a world of just narrow banks. You can turn around and say maybe we would not have had the problem in the first place."[106]