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Reforming financial markets

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Building Britain's Future
HM Government

Reforming financial markets

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by Command of Her Majesty

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Executive summary

Introduction

The world economy has been hit by a severe financial crisis, resulting in the worst global economic downturn for over 60 years. Triggered by difficulties in the US housing market that exposed the way that banks and other lenders had been underestimating real risks for too long, the crisis spread so quickly throughout global financial markets that banking systems around the world were severely destabilised. As a result, the impact has spread beyond the financial system, hitting economic growth, prosperity and jobs throughout the world.

First and foremost, the crisis has been caused by the failure across the world of many in the banking sector, including boards and investors, to understand the true risks created by the innovation and rapid growth of interconnected, globalised markets for financial services in recent years. The firms that have failed in the UK typically allowed their businesses to become overextended through:

- excessive leverage and risk taking;
- over-reliance on wholesale funding;
- overdependence on particularly risky product streams, such as buy-to-let mortgages or derivatives; or
- poor management decisions in respect of acquisitions.

These failures of commercial judgement brought the world's financial system to its knees in October 2008.

As a result, the Government had to intervene in unprecedented ways to protect depositors in UK banks and building societies, to enable banks to continue to lend to the UK economy during the recession, and to restore financial stability. At Budget 2009, the Treasury estimated that the cost of Government action could eventually be as high as £50bn. But the costs of Government inaction would have been far higher, as a modern economy cannot function without a stable banking system.

The way firms manage risk, the quality and quantity of capital they hold, and the way regulators monitor firms need to change. The Government will build on reforms already implemented to improve the way banks are managed and regulated in the UK, to ensure that banks and financial markets will be more resilient to any global shocks that may in future threaten our financial system.

The Government is advocating similar changes across the world, in discussion with the EU, the G20 and international partners. Reform of how banks operate globally, and improving how regulators across the world work together, will be key to preventing global financial crises from recurring in the future.

This document sets out the Government's analysis of the causes of the financial crisis, the action already taken to restore financial stability and the regulatory reforms necessary to strengthen the financial system for the future, so that consumers, businesses of all sectors and the economy as a whole continue to have access to the stable credit that is so essential to building Britain's future through growth, investment and innovation.

The origins of the crisis

Over the past two decades, we have seen unprecedented growth and innovation in the financial sector, as investors have sought new products and higher returns in an era of low interest rates. While this helped underpin growth in our economy, banks also had an obligation to understand the risks they were taking on, and to which they were exposing others. The complexity of some of these new instruments, and of the increasingly interconnected global markets that developed alongside them, was such that some banks, their boards and investors, as well as regulators and central banks, did not fully understand the dangers involved.

Banks' risk models turned out to be flawed, based on incomplete application of finance principles. The belief that risks had been distributed widely throughout the financial system by methods such as securitisation turned out to be mistaken, and the risks posed by the global increase in leverage were under-estimated. Banks' remuneration policies have added to the riskiness of the financial system, as they focussed too much on short-term profit. Market discipline proved to be an ineffective constraint on risk-taking in financial markets.

There were serious deficiencies in the corporate governance of many banking institutions. Bank boards failed to understand and probe their firms' risk-management processes, while senior management did not do enough to question the nature and sustainability of the higher returns being achieved. In turn, many institutional shareholders failed to monitor the effectiveness of banks' senior management or to challenge the decisions of bank boards. More generally, banks and investors were overly reliant on credit rating agency assessments, and did not supplement ratings with conclusions from their own analysis or due diligence.

At the same time, regulators and central banks, and many other authorities and commentators underestimated the risks that were building up in the financial system. They did not appreciate the true extent of system-wide risks or the full implications of activities outside the regulatory boundary, in particular the build-up by banks of large exposures to off-balance sheet financing vehicles, and the lack of transparency that accompanied them.

In short, the central lesson of the financial crisis is that, around the world, these issues were not sufficiently well understood. Global standards of regulation, and the global consensus on risk, failed to keep up with financial globalisation and innovation. This was not simply a question of the institutional structure of regulation. Rather, it was a question of making judgements and decisions based on credible experience, knowledge and robust analysis. Many different institutional frameworks exist in different countries around the world, but no model of regulation has been successful in fully insulating a country from the current crisis.

Restoring stability

In responding to the crisis, the Government's first priority has been to act quickly to restore stability to financial markets, so that depositors are protected and banks can continue to lend. Well-functioning financial markets are critical to the economy, and so the Government has acted swiftly to strengthen the financial system. Shareholders in banks, in the UK and around the world, have lost significant sums of money. The Government has focused on protecting retail depositors.

Actions to restore stability to the financial system include:

- setting up a £50bn Bank Recapitalisation Fund to make capital available to eligible banks and building societies, taken up by Royal Bank of Scotland (RBS), Lloyds TSB and HBOS;

- the establishment of a Credit Guarantee Scheme (CGS) of up to £250bn, to provide banks with a guaranteed source of funding, and hence improve the flow of credit to the economy;
- making £200bn available under the Bank of England's Special Liquidity Scheme (SLS), first introduced by the Bank in April 2008, allowing institutions to swap their pre-existing assets (which had become illiquid) for Treasury bills over a three-year period; and
- offering capital protection for banks through the Asset Protection Scheme, which provides Government protection against future credit losses on certain assets, in exchange for a fee, to support the banks and allow them to continue making loans to creditworthy businesses and households.

A crucial feature of this support has been to secure commitments from banks to lend to companies and individual borrowers by entering into lending agreements. This has ensured that almost £40bn of additional funding, on top of the amount that banks had originally planned to lend to the economy, is available to lend during 2009.

Reforming banking regulation

It is clear from the global scale of this financial crisis that there needs to be a major reform of the way that banks are managed and how they are regulated, throughout the world. In particular, we need a new approach to tackling global systemic risks.

Action already taken

The Government has already taken a large number of important steps to reform the regulatory and legislative framework, to address the lessons already learned from the financial crisis. These steps will: reform the corporate governance of banking institutions; change the amount of capital firms will need; reduce their leverage; lead to more intensive regulation of such firms; and give the authorities new powers to deal with failing banks.

The Banking Act 2009

An early lesson from the financial crisis was the need for powers to deal with failing banks and building societies in a way that protects depositors and limits the risks to financial stability. In February 2008, the Banking (Special Provisions) Act 2008, provided temporary powers to enable the Government to deal with failing banks, which were used to resolve Northern Rock, Bradford and Bingley and the UK subsidiaries of two Icelandic banks.

These powers, which were taken on an emergency basis, were limited to a year. The Banking Act 2009 was drafted to give these powers a permanent statutory footing, and came into effect in February 2009. This Act gives the authorities permanent powers to intervene when the likely failure of a bank or other deposit-taking institution threatens financial stability, the protection of depositors' money, or the interests of the taxpayer. The Act gives the Bank of England new powers, once the FSA has determined that a bank is failing, to take the lead in resolving it. The Act was used for the first time to resolve the Dunfermline Building Society in March 2009.

The Act also made provision for the Government to introduce – by secondary legislation – a new insolvency regime for investment banks. Work is underway with a group of technical experts to consider the case for legislation; if necessary, the Government will introduce the new insolvency regime early in 2010.

Reform of bank regulation

In October 2008, the Chancellor asked Lord Turner, the Chairman of the FSA, to conduct a review into the lessons for the FSA of the financial crisis, and to identify the reforms needed to strengthen the UK's regulatory regime. Lord Turner reported in March 2009. The Chancellor agrees with his findings, and the Government will continue to support the FSA in its reform of banking regulation. Key to these reforms, which are underway, will be the FSA's plans to:

- work with its international counterparts to strengthen capital and liquidity requirements – the rules that banks must follow to ensure that they have sufficient financial resources to deal with the risks that their business involves – for example, by:
  - increasing the quality and quantity of capital held by banks;
  - increasing the capital requirements for riskier trading activities;
  - introducing a backstop "leverage ratio" that ensures minimum capital levels are maintained, to stop banks from becoming over-extended; and
  - increasing the focus of regulation on liquidity – the extent to which bank assets can be turned into cash, if necessary – alongside the ongoing strengthening of the capital regime;
- continue to increase the effectiveness and intensity of its supervision of banks, monitoring their business and their risk to ensure that they remain stable and secure, through the FSA's Supervisory Enhancement Programme (SEP) including:
  - increased regulatory resources in the FSA;
  - increased focus of these resources on large, complex, "high impact" firms;
  - focusing on the business models and strategies of firms, as well as the systems and processes they put in place to support them;
  - a shift in the approach to the assessment of approved persons, with a focus on technical skills as well as probity; and
  - investments in specialist skills, with supervisory teams able to draw on enhanced central expert resources;
- reduce the incentives for excessive risk taking by banks by tackling the problem of bankers' pay and bonuses, so that they are effectively rewarded for long-term, sustainable growth, not short-term, paper profits. The FSA is consulting on a Code to cover remuneration practices, and will be incorporating this Code into its regulatory guidelines.

These changes will ensure that banks will in future avoid the excessive leverage of the past, devote more capital to their business activities, particularly in respect of their riskier investment banking businesses, and be prudent in their liquidity management. This marks a significant change in the framework in which banks operate, and is a good basis upon which to move further.

Lord Turner's Review of regulation

In October 2008, the Chancellor of the Exchequer asked Lord Turner, the Chairman of the FSA, to carry out a thorough and systematic review of the changes needed to regulation to prevent financial crises such as the one the world has recently experienced. Lord Turner reported in March 2009 with a wide range of recommendations, including in the areas of:

- capital adequacy, accounting, and liquidity – the rules that banks must follow to make sure they have enough financial resources to cope with the risks they face;
- institutional and geographical coverage of regulation – making sure that regulation covers the right types of firm, wherever they operate;
- deposit insurance – which provides ordinary customers with protection if banks fail;
- bank resolution – the tools which the regulatory authorities can use to deal with failing banks so that the impact of their failure – on consumers, businesses, and the system as a whole – is minimised;
- credit rating agencies – supervising the activities of companies that provide markets with information on the riskiness of different financial products and creditors;
- remuneration – making sure that bank executives are not unduly rewarded for excessive risk-taking;
- macro-prudential analysis – making sure that regulatory authorities, in the UK and globally, are monitoring the build up of risks across the system as a whole;
- FSA supervisory approach – continuing to increase the regulatory capacity of the FSA, and targeting it at the most important firms; and
- firm risk-management and governance – making sure that firms have the right structures and skills in place to manage themselves and the increasingly complex risks they are taking on.

Chapter 4 summarises Lord Turner's recommendations and the Government's response in implementing recommendations across all of the areas covered.

Reform of corporate governance

It is also clear that there must be major changes to the way that bank boards function. Improved risk management at board level, changes to the balance of skills, experience and independence, and a better approach to audit, risk and remuneration are required. Institutional shareholders need to be more actively engaged in monitoring the board of the bank in which they have invested. The FSA has already taken action to vet potential board members of banks more thoroughly.

The FSA have proposed the incorporation of a Code of Practice[1] on remuneration into the FSA's Handbook and to apply it to banks, building societies and broker dealers. The Code has a general requirement that 'a firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management'. This is backed up by ten principles covering the key areas of governance, performance measurement

[1] *Reforming remuneration practices in financial services*, Financial Services Authority, March 2009 (available from www.fsa.gov.uk)

and the composition of remuneration packages. The FSA will continue to play an active role in the remuneration discussion at the EU and international level.

The Chancellor has, furthermore, asked the FSA to provide an annual report on remuneration practices, including compliance by firms with the new Code. This report will assess whether remuneration practices are likely to lead to a build up of systemic risk, and make recommendations for action if this is thought to be the case.

The Chancellor has also asked Sir David Walker to conduct a review of the corporate governance of banks and other financial firms, to recommend how financial institutions can better equip themselves to respond to lessons learnt from the crisis. Sir David's interim report is due shortly and the Government looks forward to responding.

Strengthening the UK authorities

The Government has reformed how the Bank of England and the FSA discharge their responsibilities for financial stability and regulation in the UK:

- the Bank of England: as well as responsibility for the operation of the new special resolution regime, the Banking Act 2009 provided the Bank with:
    - a clear statutory objective to protect the stability of the financial system; and
    - improved governance structures – a streamlined and modernised Court of the Bank of England, with a dedicated committee for financial stability, the Financial Stability Committee, to support its work in this area.
- the FSA: in addition to the Supervisory Enhancement Programme (SEP) – which will increase the resources and deepen the skills-base of the FSA in key areas – the FSA has recently announced a major reorganisation which will provide a new operational structure designed to better align its internal operating model to its core activities of identifying and mitigating risk and carrying out supervision and enforcement. The reorganisation also takes account of the changing role of the FSA in respect of international regulatory engagement, macro-prudential analysis and consumer financial education.

Reform of international regulation

The Government has used the UK's chairmanship of the G20 and membership of international bodies such as the IMF, FSB and standard setters to push forward reform of global standards of financial regulation and supervision.

- In April, at the London Summit, the G20 agreed principles for dealing globally with impaired assets, repairing the financial system to restore lending, strengthening financial regulation to rebuild trust, and funding and reforming international financial institutions, both to overcome the current crisis and prevent future crises. In particular, the G20 agreed to establish a new Financial Stability Board (FSB) with a strengthened mandate, as a successor to the Financial Stability Forum; to extend regulation and oversight to all systemically important financial institutions, instruments and markets; and to strengthen international standards of prudential regulation.

The Bank of England's and the FSA's tools for financial stability

The Bank and the FSA possess a wide range of tools for safeguarding financial stability. Some of these were provided by the Banking Act 2009, but many others were available long before the global financial crisis.

The Bank of England:

- ensures the stability of the monetary system as part of its monetary policy functions, acting in the market to deal with fluctuations in liquidity;
- reports on key financial stability issues through its biannual Financial Stability Report;
- oversees financial system infrastructure that is systemically significant to the UK, including statutory responsibility for key inter-bank payment systems;
- maintains a broad overview of the system as a whole, advising on the implications for UK financial stability of developments in the domestic and international markets and payment systems;
- undertakes, in exceptional circumstances and with the authorisation of the Chancellor, official financial operations, including the provision of support to individual institutions; and
- intervenes to resolve failing banks, as lead authority in the special resolution regime (SRR).

The Financial Services Authority:

- is responsible for the authorisation and prudential supervision of financial institutions, including capital and liquidity requirements;
- supervises financial markets, securities listings and clearance and settlement systems, alongside supervision of institutions, with an extensive suite of enforcement powers to ensure compliance, including both administrative and criminal sanctions;
- manages the conduct of operations in response to problem cases affecting firms, markets and clearing and settlements systems (this could include the changing of capital and other regulatory requirements or the facilitation of a market solution involving, for example, the introduction of new capital into a troubled firm);
- takes the decision to "trigger" an institution into the SRR, based on its judgement that the firm is failing or is likely to fail its regulatory threshold conditions and that action cannot be taken to bring it back into compliance; and
- has broad powers to gather and share the information the authorities require to inform their roles.

Both the Bank and the FSA also have a major influence on the development of global regulatory standards, through their membership of international standard-setting bodies, such as the Basel Committee on Banking Supervision, International Organisation of Securities Commissions, and others.

To facilitate enhanced cross-border cooperation between national authorities, regulators are now, as proposed by the Government, setting up supervisory colleges of the prudential supervisors of the largest and most internationally active cross-border groups.

A key part of the new global framework will be agreed at EU level. The Government believes that Europe's ability to identify and manage system-wide prudential risks needs to be enhanced. The Government also believes that the EU needs to develop the quality and scope of rules applying to firms, and ensure their proper enforcement. The Government has therefore responded positively to the findings of the de Larosiere report, presented on 25 February 2009 to the European Commission. In particular, the Government welcomes the agreement at the June 2009 European Council to establish a European System of Financial Supervisors (ESFS) and to create a new European Systemic Risk Board (ESRB). The latter would implement the international model, where the IMF and FSB assess macro-financial risks and propose policy responses, by focusing in a greater level of detail on specific implications for European countries.

To ensure a more prudent use of securitisation techniques, and address the problems caused by the "originate and distribute" model, the Government has also welcomed the EU's proposals to require issuers to retain 5% of the risk to be securitised.

The Government will ensure that offshore banking centres do not offer firms an opportunity to avoid effective regulation. In April 2009, the G20 agreed on the importance of protecting public finances and international standards against the risks posed by non-cooperative jurisdictions, and called on the appropriate international bodies to conduct and strengthen objective peer reviews. Domestically, the Government announced in autumn last year an independent review of the long-term opportunities and challenges facing the British Crown Dependencies and Overseas Territories as financial centres, which have been brought into focus by recent financial and economic events. The final report will be published in the fourth quarter of 2009.

Next steps

Taken together, the steps described above represent significant reforms of our financial system and will build a more resilient global financial system. But, there is a need for further, more fundamental, changes to regulation in the UK and internationally, to prevent problems arising that may pose a threat to financial stability, and to deal with them if they do. The Government is proposing further reforms to banking regulation that will lead to:

- more effective prudential regulation and supervision of firms;
- greater emphasis on monitoring and managing system-wide risks;
- greater confidence that the authorities are ready and able to deal with problems when they do arise; and
- greater protection for the taxpayer when an institution needs to be resolved.

The Government will bring forward a Bill in the next legislative session to make provision in those areas where primary legislation is required. Additionally, the Government will consider whether further tools are needed to help the authorities address the potential build up of systemic risks, and work closely with the EU and international partners to achieve consensus on the tools that might be required, and how they might be used.

More effective regulation

The FSA is reforming how it approaches the regulation of individual firms, as set out above. Most of this can be accomplished within its existing powers.

However, the Government has decided to extend the powers and objectives of the FSA by:

- providing the FSA with a formal, statutory objective for financial stability, and extending its rule-making power – one of its main tools for supervision of the sector – to give it clearer legal authority to set rules whose purpose is to protect wider financial stability. This will ensure that in dealing with the regulation of firms it has the unambiguous authority to take into full account wider systemic risks;
- extending the FSA's powers to deal with individual institutions on a case-by-case basis through firm-specific interventions, so that these too can be exercised in pursuit of its new stability objective;
- enhancing the FSA's enforcement powers to enable it to deal with market misconduct, including powers of suspension and penalty for firms or individuals; and
- enabling the FSA to keep the scope of regulation under constant review, gathering the information it needs from unregulated institutions – such as structured investment vehicles – to determine whether they pose a threat to stability, and whether they should be brought under formal FSA supervision.

These measures will complement the FSA's new, more intensive, approach to regulating firms.

Better monitoring and management of systemic risk

The Government believes that the UK's institutional framework – the FSA responsible for conduct of business and prudential regulation for all financial services firms, the Bank of England responsible for financial stability – remains the right one.

The framework of 1997 established the FSA as the single regulator responsible for supervising all financial institutions, and gave the Bank of England responsibility for contributing to the maintenance of the stability of the financial system as a whole. This replaced the old system of several different bodies all acting with different powers and legal authority. It reflected developments in the financial sector in which large firms increasingly provided a wide range of products and services; responded to questions over the effectiveness of banking supervision and problems of domestic and international coordination; and allowed the Bank of England to concentrate on monetary policy and financial stability overall without the distraction of day-to-day supervision of banks.

Global developments in the last twelve years have further strengthened the case for this framework. Financial institutions and markets have become more global and complex and international coordination between supervisors more important. Other financial centres have since adopted a similar model, including Canada, Germany, Japan, Singapore and Switzerland.

The current framework remains the right one for the UK, but it will be strengthened further through increased powers for the Bank and FSA, better coordination between them, and strengthened governance and greater transparency.

In the Banking Act 2009 the Bank's existing responsibility for financial stability was formalised through a new statutory objective. This requires the Bank – through its Court, and on the advice of its new statutory Financial Stability Committee – to develop its strategy for financial stability. One of the existing key responsibilities of the Bank of England, which will continue to be a significant feature of its new role, is to analyse and warn of emerging risks to financial stability in the UK, principally by means of its Financial Stability Report, published twice-yearly.

It is important that the Bank retains this independent voice, to warn publicly of risks facing banks and financial markets in the UK.

The Government believes that this important role should now be enhanced in two ways. First, the Bank should, in future, identify in its Financial Stability Report:

- risks to the UK financial sector and the UK economy;
- specific actions which could be taken to counter the systemic risks identified in the Report;
- an assessment of their likely effectiveness; and
- consideration of whether these actions should be implemented by the Bank, the FSA, the Government, or whether they require internationally coordinated action.

Secondly, new arrangements need to be put in place to strengthen the coordination of the authorities generally, including formal and transparent evaluation of the risks identified by the Bank, and assessment of the necessary actions that need to be taken.

At present, a Standing Committee of the Treasury, the Bank and the FSA, established under a Memorandum of Understanding, serves as the forum for discussion and coordination of the activities of the authorities in financial stability. This has played a vital role in enabling the authorities to move quickly and decisively at key moments in the crisis, for example in the resolution of Bradford and Bingley and the Dunfermline Building Society, and in the emergency recapitalisation of the banks. But the Government believes it can be strengthened by introducing a more formal and transparent structure.

The Government therefore intends to legislate in the Autumn to create a Council for Financial Stability (CFS) which will replace the Standing Committee. Key features of this Council will be:

- membership consisting of the Treasury, the FSA and the Bank of England, with the Chancellor of the Exchequer as chair;
- formalising the operation of the Council on a statutory basis, providing it with clear responsibilities, to be set out in published terms of reference;
- increased public transparency and accountability, with minutes of meetings published quarterly;
- regular standing meetings to discuss the authorities' assessment of systemic risk – including through discussion of key publications such as the Bank's Financial Stability Reports and the FSA's Financial Risk Outlooks – and to consider what actions are needed; and
- meetings when particular risks to financial stability arise and action to intervene or resolve these threats needs to be considered. The FSA and the Bank will retain all their existing responsibilities and remain accountable for their actions. But the CFS will provide a means of coordinating the activities of the authorities whenever it is necessary to do so. As set out in the Banking Act 2009, any resolution requiring the use of public money is ultimately a decision for the Treasury. The quick and decisive action to resolve the Dunfermline Building Society demonstrates how these arrangements will work in practice.

One of the key issues which the new Council will consider at its first meeting is the question of remuneration. The FSA will present its new code, providing an update on compliance by the sector and its judgement on whether risks continue to be posed by remuneration practices by firms.

The Government will also consider mechanisms for increasing the democratic accountability of the CFS, through greater Parliamentary scrutiny.

Dealing with failure

More effective regulation should help limit problems that could threaten financial stability, but no system of regulation can – nor indeed, should – prevent problems from arising in all circumstances. That is why the Banking Act 2009 has provided the authorities with new powers to intervene if a bank or building society fails, to allow institutions to be resolved in a way that minimises the impact on their customers and the system.

Globalisation has led to the emergence of larger, more complex financial institutions whose operations span many countries. Managing the failure of such a firm would pose a particular challenge. But the authorities need to ensure that their powers are adequate to deal with the potential failure of any institution.

The Banking Act 2009 recognised this by providing the power for the Government to nationalise bank holding companies where the failure of a deposit-taker within a group would cause a wider threat to financial stability. Such an approach has recently been adopted in the US Government's regulatory reform plan.[2] The UK is now consulting on resolution arrangements for investment banks, and intends to bring forward any necessary secondary legislation in this area early in 2010.

More action is needed, however, to ensure that the particular problems posed by "high impact" firms are better managed. The Government's approach to this problem is fourfold:

- stronger market discipline: the Government is, through the work of the Walker Review and the FSA's Code of Practice – which is to be added to the FSA handbook – providing guidance on standards of discipline in corporate governance and remuneration. This should form a framework for action by market participants – boards, senior management and shareholders – on whom the responsibility for market discipline must ultimately lie;
- better regulation: as with all firms, larger firms will need to increase their capital and liquidity resources in line with the FSA's new approach to regulation set out above. In addition, the Government believes that systemically significant firms should be more stringently regulated, which may require such firms to hold capital and maintain liquidity at a level that reflects both the likelihood of their failure and the impact their failure might have on the system as a whole. It will be important that such an approach is agreed and implemented in a globally coordinated manner;
- managing failure: the Government believes that all firms should have detailed, practical resolution plans for dealing with their own failure, and in particular expects the FSA to work with "high impact" firms to make sure they have such plans in place. This will mean ensuring that their legal structure facilitates resolution, should that be necessary. The Bank of England, as lead resolution authority under the Banking Act 2009, should also be involved in the evaluation of resolution plans; and
- better market infrastructure: improving the infrastructure of key markets such as securitisation and specific derivatives, will reduce systemic risk generally, and help mitigate the risk of large, complex firms failing. The Government believes that derivatives need, as far as possible, to be standardised, liquid and have price transparency, and should be cleared through central counterparties.

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[2] *Financial regulatory reform: a new foundation*, US Treasury, June 2009, p.24 (available from www.financialstability.gov), p.76

To support these efforts, the FSA's principles of regulation will be updated in legislation so that it is able to take into account the impact of the failure of a firm in conducting its regulation and supervision.

Taken together these measures will address the issue of systemically important firms by minimising the likelihood that a systemic firm might fail, and reducing the impact if it does.

The Government believes that this approach is more effective than the proposal of imposing formal limits on the activities of financial firms through legislation. This is often called the Glass-Steagall approach, named after the US legislation (now repealed) that introduced such limits after the banking crisis of the 1930s. Similarly, the Government does not support placing arbitrary limits on the size of banks. The crisis has shown that banks can fail and pose a systemic threat whether they are big or small, simple or complex. There is no evidence that insulating the deposit-taking business of banks from other activities (particularly trading) would have made them less likely to fail during the recent crisis or that the systemic impact of any failure would have been reduced. Furthermore, there would almost certainly be losses in efficiency as well as significant difficulties in implementing and enforcing workable limits, both domestically and internationally.

Protecting the taxpayer

When banks fail, there is always a bill to be paid – for example, the cost of paying out depositors, or of resolution activities. The Government is clear that the FSCS should be financed by the financial services industry, because all parts of the industry benefit from the extra confidence that the existence of effective deposit protection measures gives to their customers. This also protects the taxpayer.

Therefore, most of the costs of recent resolutions have been, or will be, met by the financial services industry, through the Financial Services Compensation Scheme (FSCS). But failures can be expensive, and recent experience has shown that the FSCS cannot meet the full costs of a substantial failure immediately by raising levies from the industry. Consequently, the Government has had to step in, lending the FSCS the money it needs at an appropriate rate of interest, to ensure that this does not amount to a subsidy to the industry.

A better long-term approach to financing the FSCS is pre-funding, which would allow the industry to contribute to the funding of such costs before a major failure occurs.

The Government believes that, subject to the results of further work, including consultation it will be appropriate to move towards the introduction of a pre-funded element in the FSCS covering the deposit-taking class. This will provide a further protection to the taxpayer.

It would be inappropriate to begin a transition to such a scheme given the current situation, so the Government has decided that pre-funding will not be introduced before 2012, and when pre-funding is introduced, the initial levy will not be set at a level which would compromise financial stability or undermine efforts to strengthen the banking system.

Future reforms

The reforms already implemented, together with the next steps set out above will represent a major change to the way firms will be regulated, and will limit the risks of further financial crises in the future.

The Government, with international partners, is also looking at what further measures will be needed to help the authorities address the build up of potential systemic risks which could, if left unchecked, lead to further problems in the future.

The key is to establish what tools could be used to achieve such an effect, whether they would prove effective and what wider implications would need to be considered if such tools were used. Some of the tools under examination are:

- international rules which require additional capital to be set aside during periods of strong growth;
- discretionary variations of regulatory requirements by national authorities; and
- particular restrictions on loan products – for example, maximum loan to value ratios for mortgages.

These measures can only be effective if implemented on an international basis. The Government is working with international, and in particular, European partners on reaching a consensus. The Government is ready to take steps to implement such proposals in the UK. But it would be premature to decide on the institutional responsibility until it is clear what the new tools are, and how they should be used.

A competitive and fair market for consumers

Governments around the world have acted decisively to support their financial systems. This has been necessary to protect depositors, ensure that banks lend to the economy and restore financial stability. The Government remains committed to ensuring that the market for financial services in the UK remains competitive and fair for consumers.

In particular, the Government recognises that consumers, faced by the events of the global financial crisis, will need additional support and protection as they engage with providers of the financial services they need to manage their day-to-day lives. To achieve this, the Government is proposing:

- measures to raise financial capability, including through the provision of a national money guidance service;
- improving access to simple, transparent products so that there is always an easy-to-understand option for consumers who are not looking for potentially complex or sophisticated products;
- better and faster ways of dealing with widespread complaints when providers get it wrong, for example, by streamlining the FSA's powers to impose a settlement, and by enabling a representative body to bring an action on behalf of a group of consumers to enforce their rights and obtain collective redress; and
- building on the significant steps already taken by the Government and the FSA to further improve the arrangements for depositor protection.

Looking further ahead, the Government recognises the important role that competitive markets play in providing consumers with value, innovation and choice. Competition is a vital part of any effectively functioning market, and the Government's strategy sets out and consults on measures to:

- strengthen competition, including through increased joint working by the OFT and the FSA;
- ensure a strong focus on market access by proposing the FSA consider the impact on market access of all proposed regulatory changes and that the OFT should address market access as part of its annual updates of its Financial Services Strategy;
- examine the possibilities of new technology to further encourage new entrants;

- support competition and choice through diversity, most importantly through maintaining a strong mutually-owned financial sector, by ensuring that its regulatory and legislative framework is modernised, supporting better governance, and considering its needs for capital and funding; and
- continue to progress the Government's exit strategy from its recent interventions in financial markets.

Summary

The Government's aim is for enhanced supervision of banks, better international standards, and a more responsible and efficient global financial services sector. The Government's strategy will strengthen regulation and supervision, and support better corporate governance so that, in future, financial crises will be less likely and less damaging. This will enable the financial sector to continue to play its part as a key driver of economic prosperity.

The nine chapters of this document set out the Government's analysis of the causes of the financial crisis, action already taken to restore financial stability, and the future regulatory reforms necessary to deliver the Government's aims for reformed financial markets.[3]

[3] The document also includes a number of technical annexes. Annexes A and B contain consultation questions on specific legislative proposals, and areas for wider discussion, respectively. Annex C summarises the impact assessment – which is published in full on the Treasury website. Annex D provides details of how to respond to the consultation. Annex E contains a list of abbreviations and a glossary of terms.

1 Global financial markets

This chapter introduces the Government's strategy for reform of financial markets. It:

- explains the importance of financial services and markets to the UK economy, and the pre-eminence of the UK as a global financial centre; and
- describes the role played by the UK regulatory framework in supporting the efficient operation of UK financial markets.

The importance of financial markets to the UK economy

1.1 Financial systems are crucial to the operation of modern economies. They determine the efficiency with which savings are channelled into the most productive investments, and how risks are managed throughout an economy. As innovations and new business processes emerge to replace less efficient ones, finance is required for them to become commercially viable and so promote greater prosperity.

1.2 The financial system supports the wider economy – individuals and businesses in other industries – by:

- providing finance for individuals, households, business and governments;
- helping business and households to manage their risks effectively;
- allowing society to accumulate wealth and manage risk; and
- providing mechanisms such as payments systems through which businesses and households carry out transactions quickly, cheaply and reliably.

1.3 Furthermore, well-functioning markets make monetary and fiscal responses operate more effectively, helping to minimise economic and social costs when economies face shocks, and ensuring that shocks to certain industries or regions can be more easily absorbed in the economy.

1.4 The health of the financial system, as the core mechanism for allocating resources efficiently throughout the economy, is therefore central to economic prosperity and standards of living. A number of studies show that the efficiency of a country's financial system is critically important in determining its economic growth and dynamism.[1] Studies also suggest that well-functioning banks have a disproportionately positive impact on lower-income individuals, by creating more equal access to capital.[2]

1.5 What has also become clear during the events of the last two years is that financial markets can also operate in ways that can have a negative impact on the economy. The global financial

[1] For an extensive survey see *Finance and Growth: Theory and Evidence (NBER working paper no. 10766)*, R Levine, September 2004

[2] *Rethinking banking regulation*, JR Barth, G Caprio and R Levine, 2006

crisis has triggered a worldwide downturn, with serious consequences for growth and prosperity around the world and here in the UK. A strong, thriving financial sector can make a positive contribution to the economy, but its growth needs to be managed – by market participants and by regulators – in a way that supports sustainability and long-term growth.

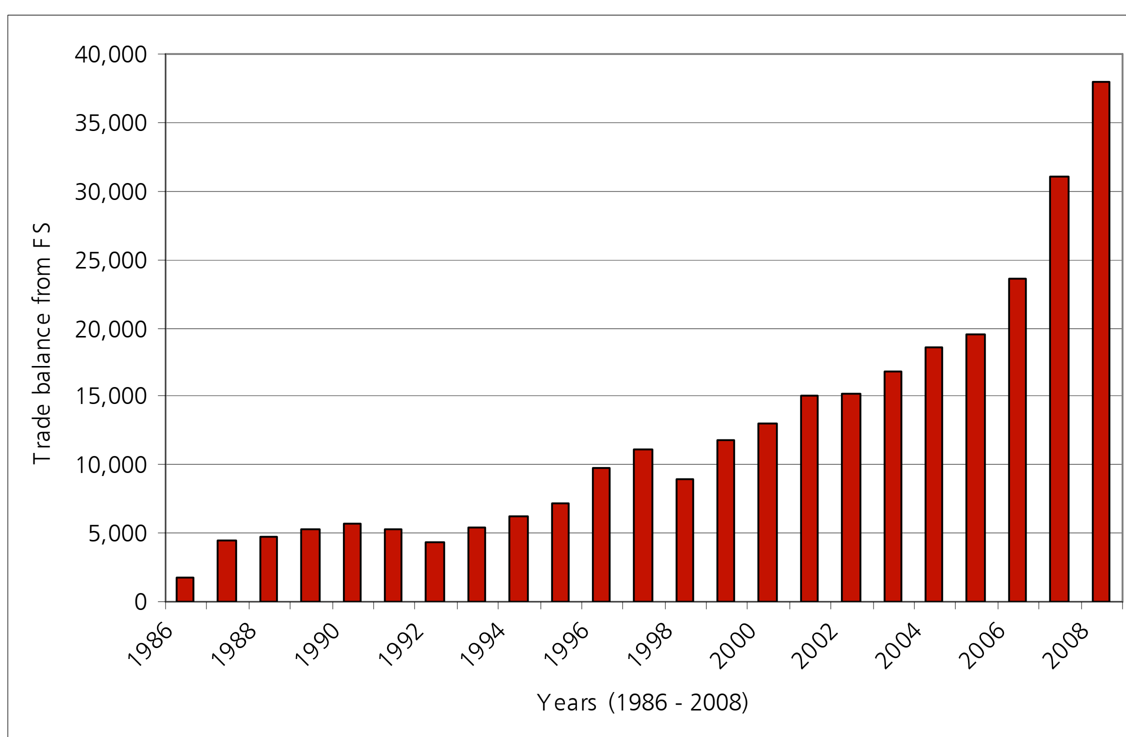
The contribution of the financial sector to the UK economy

1.6 In the UK, in addition to playing a pivotal role in supporting economic growth, the financial services industry is a significant sector of the economy in its own right. It:

- accounts for around 8 per cent of UK output;
- employs more than one million people; and
- contributes positively to the UK balance of payments, with a trade surplus in financial services of £38bn in 2008 (chart 1.A. shows how this surplus has increased over the last two decades).[3]

1.7 In addition, over the past nine years, the financial sector has contributed over £250bn to the public finances through Corporation Tax, Income Tax and National Insurance Contributions alone.

Chart 1.A: Balance of trade surplus from financial services, 1986 - 2008



Source: Office for National Statistics

1.8 London, as one of the leading global financial centres, is the main centre for financial services activity in the UK. However, a recent report prepared by a group of financial services leaders, co-chaired by Sir Win Bischoff and the Chancellor of the Exchequer ("the Bischoff group") shows that London is far from being the only financial centre in the UK.[4] For example:

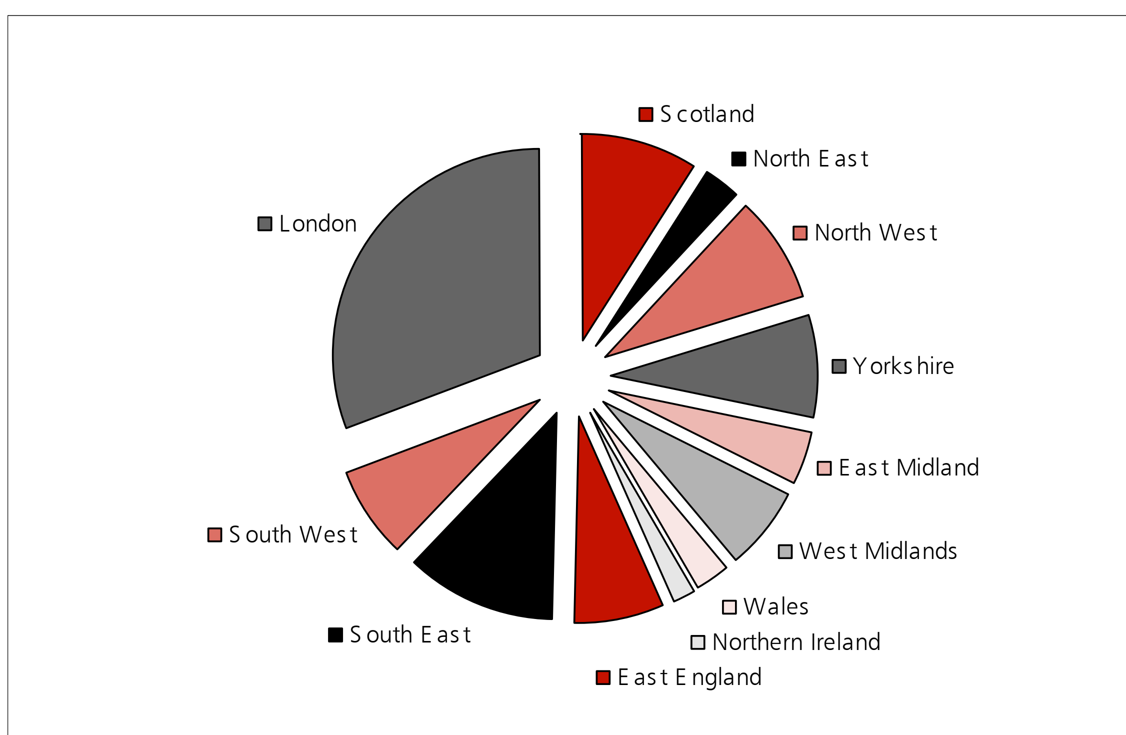
[3] See *UK international financial services – the future*, HM Treasury, May 2009 (available from www.hm-treasury.gov.uk)

[4] See *UK international financial services – the future*

- Edinburgh is an internationally recognised centre for asset management and insurance;
- Leeds, together with neighbouring cities, is an important centre for finance-based professional services; and
- the South-West of England is a region increasingly developing strength in financial services, with insurance, mortgage, client service and back office providers based throughout the region.

1.9 This diversity is reflected in patterns of employment in the financial services sector across the UK. Just under a third of jobs (around 300,000) in the sector are based in London. However, significant numbers of people are employed in financial services in every country and region of the UK, including over 100,000 in the South East, 170,000 in Yorkshire and the North West, and nearly 100,000 in Scotland.

Chart 1.B: Employment in the UK financial services sector



Source: UK international financial services – the future, p.20

Box 1.A: Are financial services too important in the UK?

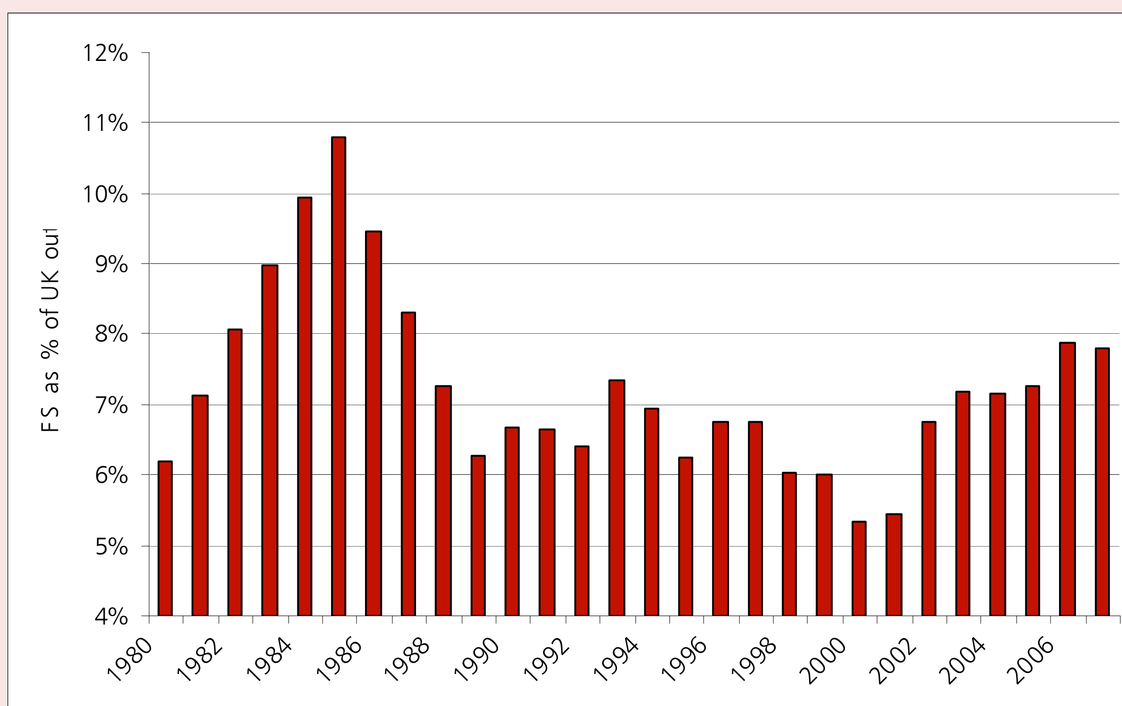
It is sometimes argued that in recent years the financial services sector has grown too large and, relatively speaking, too important, to the United Kingdom economy.[5] The question is whether the UK economy risks becoming unbalanced in its reliance on the financial sector.

This issue is considered in the Bischoff group's report on UK financial services, which notes that the sector's 8 per cent share of the economy is:

- similar to that of the USA, and comparable European countries;
- significantly less than other modern service-led economies such as Singapore and Hong Kong; and
- significantly less than the share of UK output of the manufacturing sector, which is just under 14%.

It is also interesting to note that the current level of contribution to output made by the financial sector is not particularly high when compared to historical data from the last two decades.

Financial services as % of UK output, 1980-2007



Thus, there is evidence to suggest that the financial sector has not become anomalously unbalanced, relative to the rest of the economy. However, it has been argued that the financial sector contributes disproportionately to the overall UK tax take, and that the public finances have become potentially vulnerable in their reliance on financial services.

The Government believes that the proportion of tax paid by the financial sector reflects the added value that it contributes to the UK economy.[6] The Government will continue to monitor trends in tax contributions from this and other sectors to analyse the effect on the long-term trend in public finances, taking into account market developments and innovation.

[5] See for example *Rebalancing the UK economy: a long time coming*, Ernst & Young ITEM Club, May 2009 (available from www.ey.com)

The UK as a global leader in financial services

1.10 Financial services is also one of the sectors where the UK continues to maintain a distinct advantage.[7] As highlighted by the Bischoff report, the UK-based international financial services sector plays a pivotal role in the global economy. For example:

- in 2008 the UK held a 70 per cent share of the international bonds market and an 18 per cent share of cross-border bank lending, more than any other country;[8]
- the UK is the leading international centre for foreign exchange trading, and also has leading positions in equity, bond and commodities trading;
- the UK asset management industry is a leading provider of services to global clients, including Middle Eastern and Asian sovereign wealth funds, fund managers from other financial centres and private clients from around the world, with London being Europe's hedge fund capital;
- the UK is a major centre for the private equity industry, with 12 per cent of total funds being raised in the UK;
- the UK is a major global insurance hub, with the underwriting capabilities of London (including, but not limited, to Lloyd's), investment services in London and Edinburgh, and support services provided around the country; and
- the UK is a centre for innovation in financial services, developing global leadership in markets as diverse as interest-rate derivatives, carbon permit trading and Islamic finance.

1.11 The Government remains confident in the UK's position as a major international financial centre over the medium- to long-term, and has been working together with the financial services industry over the past year to establish a clear direction for the sector over the next 10 - 15 years. As part of this work, the Chancellor of the Exchequer set up the Rights Issue Review Group (RIRG) to examine and to recommend to him measures that could be taken to make equity-raising more efficient and orderly.

1.12 The RIRG report was published in November 2008, and made a number of recommendations to improve the efficiency of rights issues in the short- and medium-term. Formerly, rights issues in the UK could take at least 39 days. Rights issues can now take as little as 17 days, which is a significant improvement and reduces the period when a company (and its reputation) is at risk and its share price open to potential abuse.[9]

The UK's competitive advantage in financial services

1.13 The UK's position as a leading international financial centre owes much to its global trading heritage, tradition of openness to foreign entry, consistent and transparent institutional setting, and ability to adapt to new market opportunities as they arose. There are four inter-related elements that have been pivotal in enhancing UK's status as a leading international financial centre. They include: its strong internationalism; its breadth; its liquidity and the contribution of regional financial centres outside London.

[6] *UK international financial services – the future*, p.20

[7] See *New industry, new jobs – building Britain's future*, HM Government, April 2009 (available from www.berr.gov.uk)

[8] See *UK international financial services – the future*

[9] For a list of the Rights Issues Review Group's recommendations, see *LIST! Issue No. 21*, UKLA Publications, May 2009 (available from www.fsa.gov.uk)

Internationalism

1.14 The UK's tradition of openness to foreign investment and ownership has enhanced its links with global and regional financial centres, especially in emerging economies with rapidly growing needs for capital-raising and inward investment. As highlighted in the Bischoff report, the UK is a core centre for international financial institutions across the world, with approximately 600 foreign financial institutions authorised for business. The UK welcomes different classes of investors from all over the world, ranging from venture capital firms to sovereign wealth funds.

Breadth

1.15 Drawing on our historical role in financing and insuring global trade, the scope of financial services available in the UK today is unparalleled. The UK, in particular London, is a major cluster in banking, insurance, capital markets, fund management and private wealth management, supported by robust clearing and settlement infrastructure as well as widely respected professional services in law, accounting and management consulting. More recently, the UK authorities have worked with the financial services industry to foster solutions in Islamic products and carbon trading.

1.16 Encouraging diversity in its financial markets has allowed the UK to attract a large body of individual and institutional investors, which drives scale and liquidity. Openness and transparency help instil market confidence and encourage institutions to increase the scope of financial products on offer, giving investors and borrowers the choice between different asset classes and financing vehicles in accordance with their required financing horizon and risk profile.

Liquidity

1.17 Borrowers and investors alike value scale as it provides a market with liquidity. Liquidity, in addition to openness and transparency, encourages effective price discovery and fundraising at the lowest cost; facilitates more accurate assessments of firms' real market value; and the spreading of different types of risks more evenly across the economy.

1.18 London has been successful at building its scale and liquidity. It is a leading centre for trading international bonds and is estimated to account for around 70 per cent of global trading. The London Stock Exchange has a higher number of foreign-listed firms than any other exchange. Firms from emerging markets seeking to demonstrate their global credentials often choose London as a listings destination. This facilitates the transfer of management and technical knowledge to firms, which complements firms' efforts to grow in their home markets.

Contribution of financial centres outside London

1.19 The UK financial services industry is spread across the country. London accounts for only around 44 per cent of the UK-wide gross value-added in financial services, with the next largest contributors being the South East and Scotland. London generates just under one-third of overall UK financial services jobs. These figures show that financial centres outside London are a crucial segment of the UK's entire financial services value chain – supporting London's role as a large-scale international financial centre but also allowing the financial sector to offer its expertise to a wider global market.

1.20 UK regions are often locations for processing centres, customer support functions and associated services such as the legal profession and consultancy. Outside London, financial centres like Edinburgh, Cardiff and Belfast have developed their own specialties, and some have combined their strengths in finance and professional services with commercial hubs (e.g. Leeds and neighbouring York) to tap into a wider business market. These clusters have both

encouraged and yielded a sustained supply of highly skilled and technically proficient staff, trained at local universities, which in turn have strong links to industry to ensure the latest ideas and research are brought to market.

Regulation as a critical success factor

1.21 The Bischoff report identified regulation as an important factor for the stability and success of financial centres like the UK. To maintain the future pre-eminence of the UK's international financial services markets, the Bischoff report considers that an effective regulatory framework – specifically for the banking sector – will be critical.[10]

1.22 As an international financial centre hosting many large firms, and therefore requiring close cooperation between the FSA and overseas regulators, the UK will continue to lead and engage in the European and global debate on the development of regulatory standards. The next section describes this in more detail.

The UK's regulatory approach since 1997

1.23 The Government's long-term objective is for fair, efficient and stable financial markets, which support economic growth and prosperity. In practice, this means markets that facilitate and support the performance of the overall economy, act to moderate and dissipate the financial imbalances that can arise in any modern economy, and meet the needs of members of society. Financial markets fundamentally depend on promises to pay or repay at some time in the future. As a result, they are vulnerable to abuse, distortions and occasional losses of confidence. Efficient financial regulation is essential to mitigate these risks, and support fair, efficient and stable financial markets.

A single financial regulator

1.24 In 1997 the Government established a system of financial services regulation working through the Financial Services Authority (FSA), the Financial Ombudsman Service (FOS) and the Financial Services Compensation Scheme (FSCS).[11] These are operationally independent from the Government – although subject to the provisions of the Financial Services and Markets Act 2000 (FSMA). These unified bodies replaced the previous system of multiple self-regulatory organisations (SROs), complaint adjudicators, and compensation schemes. In parallel, the Bank of England was given responsibility for the overall stability of the financial system.

1.25 The main driver of the move to a unified financial services regulator was the blurring of boundaries between financial activities. By the late 1990s, an increasing number of firms were providing a wide range of financial services and so were subject to separate regulators in each market, reducing the effectiveness and increasing the cost of regulation. In addition, scandals – such as the mis-selling of personal pensions in the 1980s – had discredited the high degree of self-regulation that existed within the system.

1.26 Furthermore, the failures of BCCI and Barings had led many to question the effectiveness of banking supervision in the UK. The decision in 1997 to give the Bank of England independence for monetary policy provided a natural moment to reconsider the framework. And given the developments in the markets, there was a strong case for locating the prudential supervision of all regulated firms in one place – the FSA, as the new single regulator – with the Bank of England, as the central bank, responsible for contributing to the stability of the financial system as a whole.

[10] *UK international financial services – the future*, p.38

[11] There is a separate regulatory regime for occupational pensions under the Pensions Regulator (TPR), which works closely with the FSA on issues of mutual interest.

Box 1.B: Different approaches to financial supervision[12]

- Institutional. The institutional approach is one in which a firm's legal status (for example, a bank, broker-dealer, or insurance company) determines which regulator is tasked with overseeing its activity from both a prudential supervision and a business conduct perspective.
- Functional. The functional approach is one in which supervisory oversight is determined by the business that is being transacted by the entity, without regard to its legal status. Each type of business may have its own functional regulator.
- Twin Peaks. The twin peaks approach, a form of regulation by objective, is one in which there is a separation of regulatory functions between two regulators: one that performs the prudential supervision function and the other that focuses on conduct-of-business regulation.
- Integrated. The integrated approach is one in which a single universal regulator conducts both prudential and conduct-of-business regulation for all sectors of financial services business.
- The U.S. exception. The U.S. structure is functional with institutional aspects, with the added complexity of a number of state level agencies and actors (although the recent regulatory reform plan proposes a degree of rationalisation of federal supervisory authorities).

The UK adopts the integrated approach. The Government's view of the advantages of this approach over the other supervisory approaches is set out in the main text below.

1.27 The introduction of the FSA as a universal regulator with a single set of powers has brought a number of important benefits:

- it has given the FSA access to the information needed to take a complete view of financial firms' activities and the overall risks being taken across all markets;
- it has delivered better coordination of regulatory engagement with all the activities of increasingly diversified financial services providers, increasing the effectiveness and efficiency of the regulatory process, and enabling the FSA to act more decisively;
- it has significantly reduced the possibility of firms choosing or "arbitraging" between regulators to achieve the least restraining regulation;
- it has reduced regulatory duplication and costs for firms, as firms are able to deal with a single regulator across all the product markets in which they were dealing;
- it has clarified the regulatory landscape for the consumer, in many cases making it much easier for them to negotiate decisions about often complex products, while providing rights and mechanisms for redress; and
- as the financial services industry becomes increasingly international, a single regulator makes the process for international engagement clearer and more effective.

[12] Adapted from *The structure of financial supervision: approaches and challenges in a global marketplace*, Group of 30, October 2008 (available from www.group30.org)

1.28 The creation of a single financial services regulator was a radical step. The UK was the first major international financial centre to integrate financial regulation in this way. The benefit of this regulatory structure has been widely recognised as an advantage for the UK. For example, the UK's approach can be compared favourably with the highly fragmented system of regulation in the US, which the current administration is starting to reform. The integrated supervisory model has been adopted by a number of countries[13].

Box 1.C: Problems with the UK regulatory framework prior to 1997

Prior to the reforms to financial services regulation implemented by the Government since 1997, regulation and supervision of UK financial markets was split between several bodies. The Bank of England was responsible for bank supervision, the Department of Trade and Industry for insurance regulation, and a number of self-regulatory organisations (SROs) and other bodies had regulatory responsibility for other financial services activities.

But after the "Big Bang" and other deregulatory activities of the 1980s, financial institutions were increasingly providing a variety of different services, with the result that many firms were being regulated by a variety of different bodies with different rules. For example, before the creation of the FSA over 800 financial services firms had more than one regulator and at least another 1,000 firms were members of groups with more than one regulator.

There were also accusations that some SROs paid too much attention to the views of their members and not enough to investors. There were instances of extensive mis-selling, which contributed to undermining confidence in self-regulation. Most notable was the now remedied pensions mis-selling scandal during the late 1980s and early 1990s, when more than one million people were wrongly sold personal pensions by commission-based salesmen.

Finally, the increasing globalisation of markets and financial services firms made international cooperation between regulators in different countries even more important. The collapse of BCCI and Barings were vivid examples. The task of coordinating internationally when supervising big global conglomerates was complicated by the number of separate regulators in the UK with partial responsibilities for a single firm.

1.29 In some countries, prudential regulation and conduct of business regulation for financial institutions are split between different regulatory bodies – the "Twin Peaks" model. The Government firmly believes that business conduct and prudential regulation and supervision should reside with the same body. In particular, the recent crisis has shown that conduct-of-business and prudential failings by institutions can both create systemic risk and spillover effects, so should be considered together rather than separately. For example, the current crisis arises in part from failure to appreciate the prudential spillover effects from bad business conduct in the US mortgage origination and securitisation markets.

1.30 There are also good practical supervisory reasons for avoiding splitting regulatory responsibility for prudential and conduct-of-business regulation. These include:

- disjointed action: guidance issued by two or more agencies could give conflicting information. Enforcement action could be jeopardised by a lack of understanding between the separate prudential and conduct-of-business supervisors, either as a result of information not communicated effectively, or an imperfect understanding of each others' enforcement procedures; and

[13] For evidence on single supervisory authorities, see *Rethinking banking regulation*, JR Barth, G Caprio and R Levine, 2006

- inefficiency: it would require two or more agencies to retain strong expertise in an area of regulated activity, including case workers, lawyers and senior supervisory staff. It is more effective to concentrate expertise in one place.

1.31 The Government continues to believe that the integrated framework is the right model, and remains committed to the approach of having a single financial regulator, working closely with the central bank and the finance ministry on financial stability. Its strategy for reforming financial markets is based on building and strengthening this approach, in line with actions already being taken by the FSA – such as its recent reorganisation around a strengthened integrated operational structure, which will support the wider reforms it has undertaken as part of its Supervisory Enhancement Programme. There will be no change in the current arrangements for pensions.

The international context

1.32 Consistent with the globalisation of finance over the past two decades, the Government's financial regulation framework has needed to become aligned with international agreements. This is necessary to avoid internationally mobile institutions exploiting differences in national regulations and because of the enormous spillover effects from institutions operating across borders.

1.33 Financial markets will continue to become ever more globalised, even in the wake of the crisis. It will be vital, therefore, that the Government continues to play a leading role in the coordination of the international response. This strategy therefore focuses not only on domestic, but also international, aspects of reform.

Summary

1.34 This chapter has explained the importance of the financial services sector to the UK economy, the role played by the UK regulatory framework in fostering stable, fair and efficient financial markets, and the benefits of an integrated approach to supervision. The next chapter describes the events of the financial crisis, and the actions that the Government has taken to protect the financial system and the economy.

2 The financial crisis and the Government's response

This chapter describes the development of the financial crisis that has spread across the world, significantly affecting not only financial markets, but also the global economy.

It also sets out the Government's response to the immediate and pressing challenge presented by the crisis – to prevent the economically catastrophic effects of a widespread collapse of the banking system, including through:

- supporting individual firms to avoid the failure of one bank from destabilising the system as a whole; and
- providing support to the banking system as a whole, to allow banks to continue to support the economy through the provision of finance.

2.1 A succession of shocks hit the world economy during 2007 and 2008, beginning in the financial markets – with failures in credit markets in the US and elsewhere – and leading to a steep and synchronised global economic downturn. Weaknesses in many aspects of the financial system have become apparent for the first time, affecting countries and markets around the world, and resulting in the worst global financial crisis for generations. The crisis has not been confined to financial markets, but has had resulted in significant disruption to the wider economy, severely affecting businesses and households around the world.

2.2 As discussed in Chapter 3, analysis of the causes of the crisis reveals a number of challenges to which governments, central banks and regulators around the world must respond in reforming financial markets for the long term. These challenges centre around the failings of both market participants and regulatory authorities in managing risk effectively and pre-empting the crisis.

2.3 Over the last two years, however, the response by governments around the world has necessarily had to focus on dealing decisively with the immediate consequences of the crisis. The Government has taken a leading global role during this period, and the UK's response has shown the authorities acting decisively and in concert to support the financial system as a whole, to minimise the disruption of the financial crisis to the wider economy.

The global financial crisis

2.4 Since July 2007, the global economy has been experiencing unprecedented levels of financial turbulence. This was triggered by a downturn in the US housing market, particularly the sub-prime end of the market, which many financial products created in recent years were exposed to. The instability grew steadily, peaking in the weeks following the collapse of Lehman Brothers, a US investment bank, in September 2008. It is possible to identify three phases of the financial crisis.

2.5 In the first phase, investors realised that they might have misjudged the risk in securities linked to low quality US sub-prime mortgages. As a result, prices fell leading to heavy losses for holders of these assets. As institutions sought to sell similar assets to reduce their risks, market

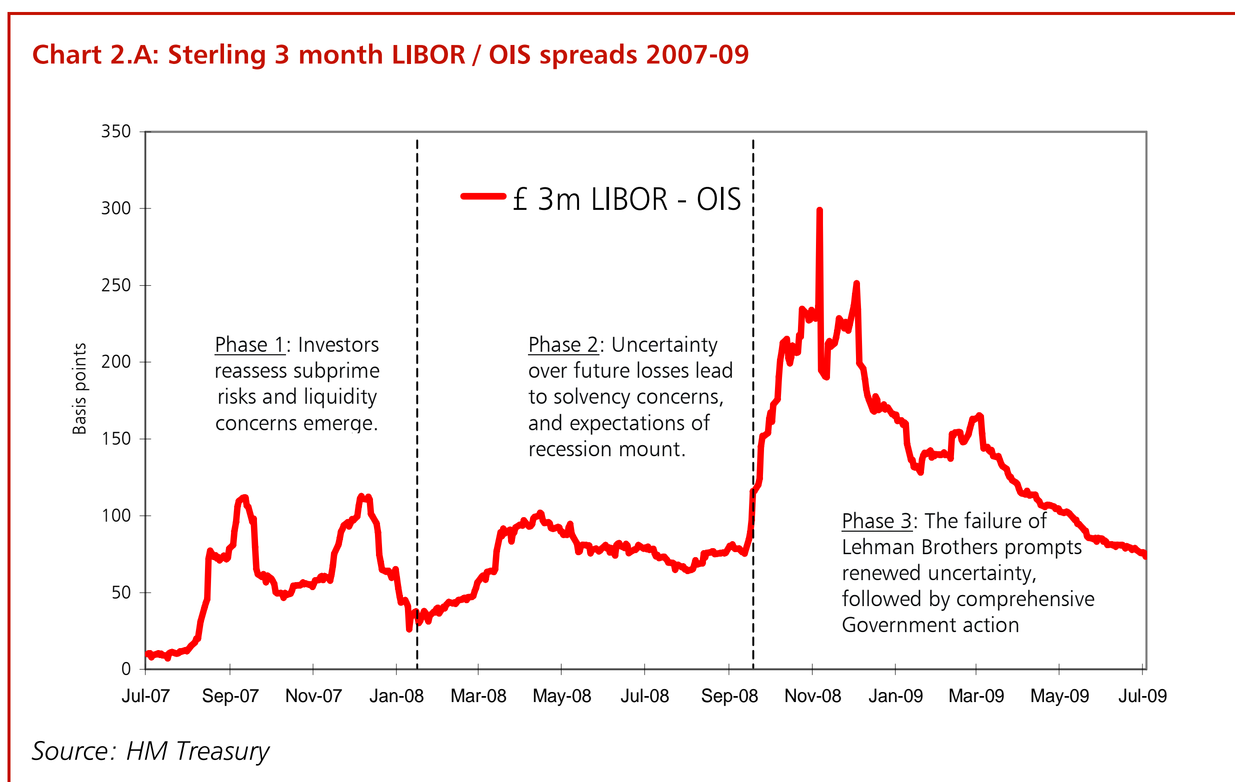
liquidity dried up. Investors then became concerned about which of their counterparties may be exposed to these losses, and began to charge a higher risk premium to roll-over inter-bank exposures.

2.6 Losses on sub-prime mortgage securities market were initially thought to be containable (at an estimated $200bn), as the global financial system had managed similar shocks such as the bursting of the high-tech bubble and the closure of the Long Term Capital Management hedge fund. However, in the second phase, financial institutions started reporting losses related to their holdings of impaired assets and investors started to question whether full losses had been revealed.

2.7 This uncertainty, combined with expectations of a slowdown in the major advanced economies, raised concerns about the solvency of a number of financial institutions. The outcome across the board was higher funding costs for all institutions. Banks responding by hoarding capital.

2.8 In the third phase, the failure of Lehman Brothers had repercussions which undermined confidence in the banking system as a whole. In autumn 2008, significant capital injections and credit guarantee plans adopted by governments all around the world were successful in stabilising confidence.

Chart 2.A: Sterling 3 month LIBOR / OIS spreads 2007-09



Source: HM Treasury

2.9 By that time, however, the overhang of impaired assets from structure finance transactions was no longer the only source of potential losses. Resulting in large part from the financial disruption, deteriorating macroeconomic conditions in the world's largest economies (the US, the Euro area, Japan and the UK), and a slowing of economic growth in a number of emerging markets, led to further pressure on banks' balance sheets. The financial market shock had filtered through to the real economy, and expected losses on traditional loans to households and companies increased. According to the latest IMF estimates, the total losses in the global financial system have reached $4 trillion.

2.10 The resulting shortage of finance led to the onset of a global recession. As recessions across the world deepened, even traditional bank loans and some of the safest securities came to be seen as increasingly risky. In response, banks held even more capital as a precaution

against future losses. A negative feedback loop of tightening financial conditions and deteriorating economic prospects had begun across the major financial centres in the world.

The Government's immediate response to the crisis

2.11 Since the crisis first broke in 2007, the Government's response has been targeted at three main areas: addressing system-wide instability; tackling problems in individual institutions; and getting credit flowing through the economy once more. These interventions share the common purpose of protecting ordinary customers of financial institutions – people and businesses – from the consequences of financial instability and restricted access to credit

System-wide Government support

2.12 After consultation with the Bank of England and the Financial Services Authority (FSA), on 8 October 2008 the Government announced a comprehensive package of system wide measures to restore confidence in the entire banking system based on the recapitalisation of the banks. Measures included:

- the establishment of a £50bn Bank Recapitalisation Fund to make available capital to eligible banks and building societies, taken up by Royal Bank of Scotland (RBS), Lloyds TSB and HBOS;
- the establishment of a Credit Guarantee Scheme (CGS) of up to £150bn, to provide banks with a guaranteed source of funding, and hence improve the flow of credit to the economy; and
- the availability of £200bn under the Bank of England's Special Liquidity Scheme (SLS), first introduced by the Bank in April 2008, allowing institutions to swap their pre-existing assets (which had become illiquid) for Treasury bills over a three-year period.

2.13 Following further deterioration in the financial markets, the Treasury, Bank of England and FSA introduced additional measures designed to encourage investors back into the market and reduce uncertainty, giving the banks both the funds and the confidence they needed to increase lending to creditworthy businesses. These measures included: [1]

- extending the draw-down window for new debt under the Government's CGS to 13 October 2009, with the intention to extend it further to 31 December 2009, subject to state aids approval from the European Commission;
- introducing asset-backed securities guarantees from 22 April 2009, extending the funding options available to banks and building societies under the CGS to residential mortgage-backed securities;
- extending the maturity date for the Bank of England's Discount Window Facility (DWF), a permanent facility which provides liquidity insurance to the banking sector by allowing banks to borrow UK Government securities against a wide range of collateral;
- establishing a new Bank of England Asset Purchase Facility (APF), guaranteed by the Government, to purchase high quality private sector assets, to improve liquidity in certain financial markets and provide the Bank of England's Monetary Policy Committee with an additional tool to use for monetary policy purposes;

[1] Further details about these interventions are set out in *Budget 2009: building Britain's future*, HM Treasury, April 2009 (available from www.hm-treasury.gov.uk)

- offering capital protection for banks through the Asset Protection Scheme providing Government protection against future credit losses on certain assets, in exchange for a fee, to support the banks' capital position and enable them to attract investments and deposits and make loans to creditworthy businesses and households;
- clarifying the regulatory approach to capital requirements, through an announcement by the FSA;
- setting up of a company, UK Financial Investment Ltd (UKFI), in November 2008 to manage the Government's shareholdings in financial institutions on a commercial basis, with an overarching objective to protect and create value for the taxpayer as a shareholder, with due regard to the maintenance of financial stability and to act in a way that promotes competition; and
- agreeing quantified and legally binding lending commitments.

Box 2.A: Managing the taxpayer's investments in UK banks

The Government has set up a company, UK Financial Investments Ltd, to manage the Government's investments in the banks; to dispose of them in full over time; and to protect and create value by fulfilling its role in the meantime in an arms-length, commercial manner.

Key to UKFI's role is ensuring that the banks in which the Government has investments are managed in a way which fully learns the lessons of recent years and the massive destruction of shareholder value that has been suffered as a result of flawed strategies, ineffective risk management and inappropriate approaches to remuneration.

UKFI is therefore engaging actively with its investee companies on key areas of strategic shareholder interest. Since UKFI took on management of the Government's investments in RBS and Lloyds:

- UKFI has overseen sweeping changes at the banks' boards. RBS has a new chairman and chief executive; seven non-executive directors have left; and the entire top executive team either has or shortly will have been replaced;
- The HBOS board no longer exists; the Lloyds board has been strengthened and a new chairman is being appointed;
- RBS has a wholly new strategy and at both RBS and HBOS the approach to managing risk is being thoroughly overhauled;
- At both RBS and Lloyds, UKFI has negotiated fundamental changes to remuneration structures, as radical as at any large bank in the world, in order to align management incentives with those of the taxpayer and to avoid reward for failure or taking excessive risks.

UKFI will continue to discharge its role through active engagement as shareholder with its investee companies, with the aim of protecting the taxpayer's investments and disposing of them in full over time.

Dealing with the potential failure of individual banks

2.14 As individual firms have come under financial stress due to particular problems that they have experienced, the Government has acted to deal with them appropriately, in addition to providing funding and capital support through the sector-wide interventions described above. The Government's actions have had three core objectives:

- to support stability and restore confidence in the financial system;
- to protect retail depositors' money; and
- to safeguard the interests of taxpayers.

2.15 Actions taken relating to individual banks in the UK since 2007 have included the following:

- Northern Rock was taken into temporary public ownership in February 2008 using the Banking (Special Provisions) Act 2008, after it had experienced severe funding problems and no buyer could be found to stabilise the bank in a way that protected the interests of taxpayers;
- in September 2008, the Government again used the Banking (Special Provisions) Act 2008 to take swift action in relation to Bradford & Bingley, with the retail deposits and branches of Bradford & Bingley transferred to Abbey following a competitive sale process and the remainder of Bradford & Bingley's business taken into public ownership;
- the recapitalisation of RBS, Lloyds TSB and HBOS in October 2008, with subsequent Government investment of £20 billion in RBS and £17 billion in what is now Lloyds Banking Group (created following the merger of Lloyds and HBOS in January 2009). The Government has since announced the conversion of its preference shares in RBS and Lloyds Banking Group into new ordinary shares, further boosting their capital positions;
- in October 2008, following the Icelandic banking crisis, action was taken to protect UK depositors in Icelandic banks. Kaupthing, Singer & Friedlander and Heritable – respectively the UK subsidiaries of Kaupthing and Landsbanki – were placed into administration following due legal process. Arrangements were put in place for the protection of retail depositors in these firms, including those in Landsbanki's UK branch, Icesave;
- in November 2008, the FSA determined that London Scottish Bank plc should be prevented from accepting further deposits as it no longer met the FSA's threshold conditions for authorisation. The bank was placed into administration later that evening, with the FSCS and Government providing protection for retail depositors;
- in March 2009, action was taken to resolve Dunfermline Building Society under the new special resolution regime of the Banking Act 2009. Dunfermline's retail and wholesale deposits, branches, head office and own-originated residential mortgages were transferred to Nationwide Building Society. Dunfermline's social housing loans and related deposits were placed into a bridge bank, wholly owned by the Bank of England (since then, Nationwide has also acquired the assets and liabilities held by the bridge bank, following a competitive auction process). A court order was made to place the remainder of Dunfermline's business into a Special Administration Procedure; and
- in June 2009, the FSA (working with the Treasury) developed a new capital instrument for building societies, offering them more flexibility in terms of their core Tier 1 capital. The West Bromwich Building Society has made use of these "profit participating deferred shares" to strengthen its financial position.

2.16 As a consequence of these actions, the Government has ensured that no retail depositor has lost money following the failure of a bank or building society, and has minimised the ultimate cost to the taxpayer.

Supporting the provision of credit to the economy

2.17 By acting to limit the risks attached to banks' existing assets through the Asset Protection Scheme, and by agreeing quantified lending commitments with banks accessing Government support, the Government has facilitated the provision of almost £40bn additional lending to the economy in each of 2009 and 2010. RBS has agreed to lend an additional £25bn on commercial terms and subject to demand over the 12 months from March 2009, and Lloyds Banking Group has agreed to lend an additional £14bn, again on commercial terms and subject to demand, over the same period. Northern Rock has also announced that it will lend up to £5bn in 2009 and up to £9bn in 2010.

2.18 In addition, major UK banks whose capital and balance sheets are not directly supported by the Government have also announced increased lending. For example, Barclays announced £11bn of additional lending to be split equally between mortgage and business lending, while HSBC has announced that it will lend up to £15bn to homeowners in 2009. This means around £50bn in additional lending by the main bank above their 2008 levels of lending. These comprehensive and coherent interventions have protected the economy from the worst impact of financial instability or bank failures, provided the resources and certainty necessary for credit growth, and agreed commitments that will get credit flowing to creditworthy borrowers, and so support economic recovery.

2.19 This demonstrates an important element of the Government's response to the financial crisis: that, alongside measures to support individual banks and the banking sector as a whole, the focus of the Government's efforts has been on seeking to minimise the impact of the financial crisis on the wider economy, and the businesses and consumers who rely upon the banking system for the finance and other services needed to manage their day-to-day activities.

International impact of UK actions

2.20 Following the Government's announcement of plans to recapitalise the UK banking system, the G7 statement in October 2008 called for "urgent and exceptional action…to support systemically important financial institutions and to prevent their failure." Euro area governments followed with similar steps to the UK, injecting more than US$290bn of capital into banks, with the US, Japan, South Korea and Switzerland also taking action. Further to the Government's actions to make available Government guarantees of eligible debt issuance to eligible institutions, other countries have adopted similar debt issuance guarantee schemes.

2.21 In January 2009, the Government announced a system-wide asset relief scheme, which would provide for a manageable maximum loss on banks' impaired assets, to complement existing liquidity and credit guarantee support for the UK banking sector. Following this, the G20 finance ministers and central bank governors agreed a set of principles for a coordinated and consistent approach to dealing with impaired assets across the global banking system. This remains a key tool for rebuilding market confidence in the banking sector and to restore lending to the wider economy.

2.22 Since then, the US has committed US$369bn to repair its financial system, and efforts to restore lending have continued with proposals to deal with legacy assets through a Public-Private Investment Programme, and a commitment to further recapitalisation as and when necessary. In the Euro area, efforts to clean up bank balance sheets are accelerating with Belgium, Ireland, Germany and the Netherlands expected to tackle more than an estimated US$250bn of impaired assets among their banks.

Summary

2.23 This chapter has described the events of the crisis and the actions that the Government has taken to protect the financial system and the economy. The next chapter turns to analysing the causes of the crisis, to inform the further action the Government will take to reform the regulatory system in the UK and internationally.

3 The causes of the financial crisis

This chapter analyses the causes of the financial crisis, identifying three factors as being particularly important:

- first and foremost, failures of market discipline, in particular of corporate governance, risk management, and remuneration policies. Some banks, boards and investors did not fully understand the complexities of their own businesses;
- second, regulators and central banks did not sufficiently take account of the excessive risks being taken on by some firms, and did not adequately understand the extent of system-wide risk; and
- third, the failure of global regulatory standards to respond to the major changes in the financial markets, which have increased complexity and system-wide risk, or to the tendency for system-wide risks to build up during economic upswings.

Emerging from this causal analysis are a number of core issues to which the Government's strategy for regulatory reform must respond:

- first, strengthening the UK's regulatory institutional framework, so that it is better equipped to deal with all firms and, in particular, globally interconnected markets and firms;
- second, dealing with high impact firms that may be seen as being "too big to fail", through improved market discipline and through improved supervisory focus on such firms;
- third, identifying and managing systemic risk as it arises across different financial markets and over time; and
- fourth, working closely with international partners to deliver the global action required to respond to the lessons of the financial crisis.

3.1 The causes of the global financial crisis will be debated for many years to come. The Government's analysis focuses on three broad factors that have contributed to the crisis:

- first, the failure of the tools of market discipline, in particular of corporate governance, risk management and remuneration. Some banks, boards and investors did not fully understand the complexities of their own businesses;
- second, regulators and central banks did not sufficient take account of the excessive risks being taken on by some firms; and
- third, the failure of global regulatory standards to respond to the challenges of system-wide risk, including:
  - adapting to the major changes in the evolution of financial markets which have lead to increased complexity and levels of system-wide risk; and

- properly addressing the tendency for cycles in risk taking and leverage in financial markets to amplify the economic cycle.

Failures of market discipline

3.2 It is important to note that, while failures of regulation and regulators – which have been debated extensively in the wake of the crisis, and to which this strategy responds – were important, the prime cause of the problem was the actions (or in many cases, inaction) of market participants.

3.3 Market discipline is of central importance to well-functioning financial markets. But, in the run up to the global crisis, market discipline failed in a number of important respects. These failures led to distortions and inefficiencies which contributed to, or exacerbated, the crisis. In particular, firms – and particularly their managers, boards of directors and institutional shareholders – failed to appreciate the extent and complexity of the risks that they were taking on, or to manage these risks effectively.

Corporate governance

3.4 In well-functioning businesses the self-interest of different stakeholders imposes discipline to avoid excessive risk-taking without commensurate compensation. However, recent experience has shown that market discipline has failed to prevent a number of deficiencies in corporate governance in the institutional investment chain. Firms' senior management must carry primary responsibility for their actions and resulting consequences. Large investors also have a responsibility to reward institutions which are following prudent and profitable long-term business strategies and to punish those with excessive risk and inadequate business models.

3.5 There were failures of senior management to question higher returns robustly and to take into account the risk of low-probability but high-impact events materialising. There were also widespread failures of governance by some bank boards in several areas, including:

- understanding and probing overall risk-management reporting;
- understanding how affiliated vehicles imply ongoing exposure; and
- how remuneration policies encourage risk-taking that may prioritise the short term at the expense of the long term.

3.6 Similarly, there were failures on the part of some owners, in the form of institutional shareholders, to recognise the extent of these deficiencies and to constrain their agents' actions through effective monitoring of and engagement with bank boards.

Remuneration practices

3.7 It is clear that remuneration practices in banks were an important factor in the crisis. Staff in certain areas of banking were incentivised through the possibility of very large rewards to pursue unduly risky practices that, although profitable in the short term, did not take appropriate account of risk in the long term. Many of these longer-term risks are difficult to quantify, but equally important not to underestimate. The Government is clear that the banking industry, both in the UK and globally, needs to develop sustainable long-term remuneration policies that take account of risk. And the same is true of other sectors of the financial services industry – for example, fund management – in which remuneration practices may have directly or indirectly contributed to excessive short-term risk-taking.

3.8 Market participants – shareholder, bank boards and other senior management – must take responsibility for ensuring strong market discipline. The focus on developing a sustainable remuneration policy that enhances financial institutions' stability and long-term profitability is

essential to ensuring that the UK, and international, financial sector operates competitively and to a high standard.

3.9 There needs to be better risk management at board level, changes to the balance of skills, experience and independence required on such boards, and a better approach to audit, risk and determining remuneration. Better ways to actively engage key institutional shareholders in monitoring a bank's board are needed.

3.10 The Government is addressing these issues through the work of the Walker Review and the FSA's Code of Practice. [1]

3.11 The FSA will incorporate its Code of Practice on remuneration into the FSA's Handbook and apply it to banks, building societies and broker dealers. The Code has a general requirement that 'a firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management'. This is backed up by ten principles covering the key areas of governance, performance measurement and the composition of remuneration packages. [2]

3.12 The FSA will continue to play an active role in the remuneration discussion at the EU and international level.

3.13 In October 2008, the Chancellor commissioned Sir David Walker, to make recommendations for financial institutions, covering:

- the effectiveness of risk management;
- the incentives in remuneration policy to manage risk effectively;
- the effectiveness of board practices, and the skills, experience and independence required on boards;
- the role of institutional shareholders; and
- promulgation of national and international best practice.

3.14 Sir David Walker is due to report his findings shortly.

Poor risk-management

3.15 Firms around the world failed to understand the nature and extent of the risks to which they were exposed – particularly the reaction of other institutions to remote rules and the correlation of risks across different markets. This was a key contributor to the global financial crisis.

3.16 Financial institutions, relying too much on data from the recent past as an indicator of future market performance, dramatically underestimated the likelihood of relatively low-probability events such as those of the last 18 months. Risk models in banks and other financial institutions turned out to be poor representations of how market participants would respond. In particular, the use by banks of value-at-risk (VAR) models, which use the volatility of the price of the asset over the recent past in order to quantify the risk entailed in marketable securities, appears to have exacerbated the tendency for financial markets to underprice risk in good times and contributed to the herding tendencies of markets.

3.17 Stress testing also proved inadequate. Stress testing aims to allow firms to assess the impact of more extreme events on their business, which are not generally captured by traditional

[1] See *Reforming remuneration practices in financial services*, Financial Services Authority, March 2009 (available from www.fsa.gov.uk)

[2] *Reforming remuneration practices in financial services*, p.29-34

risk-management models such as VAR. A recent discussion paper by the FSA[3] identifies a number of key lessons from the crisis for firms' stress testing approaches, including:

- the need for stress tests to better capture how risks may be transmitted through markets in distressed market conditions, including the second round feedback effects of other firms' responses to a common shock;
- the importance of considering the impact of liquidity shocks to key markets as a mechanism of contagion;
- the importance of ensuring that stress testing enables the identification and assessment of risk at a firm-wide level; and
- the critical importance of senior management involvement to the effectiveness of stress testing programme.

The approach to supervision

3.18 The FSA has a large set of regulatory and enforcement powers and the scope of regulated firms is wider than in many other countries. For example, the US is now proposing to regulate conduct of business of mortgage sellers, something that the UK has done since 2004. The Government believes that the powers given to the regulatory authorities and in particular to the FSA under the Financial Services and Markets Act 2000 have proven broadly adequate.

3.19 While this document does propose a number of specific, targeted, enhancements to the FSA's powers and amendments to the scope of regulation, the Government is clear that the financial crisis was not caused by a lack of powers within the UK's regulatory regime. However, the crisis has shown that aspects of prudential and macro-prudential supervision, within these powers, were insufficient.

3.20 UK financial regulation since 1997 has aimed to combine effective regulation in line with global standards. The UK has encouraged a strong global approach to supervision. However, global and national regulatory standards have placed insufficient emphasis on the development of risks across the world. Rebalancing regulatory systems towards a greater emphasis on more effective global supervision is a necessary part of financial reform.

3.21 More effective regulation should help limit problems that could threaten stability, but no system of regulation can – nor should – prevent problems from arising in any circumstances. The Banking Act 2009 has provided the authorities with new powers to intervene if a bank or building society fails, so that institutions can do so in a way that minimises the impact on their customers and the system.

3.22 Firms themselves need to be better prepared for their own failure, to minimise the consequences for the rest of the sector, the wider economy and ultimately the taxpayer. Financial institutions and regulators should take more preventative action to manage the likelihood and impact of the failure of – in particular – "high impact" firms.

[3] *A regulatory response to the global banking crisis*, Financial Services Authority, March 2009 (available from www.fsa.gov.uk)

Box 3.A: The global macroeconomic context - low interest rates, and the search for yield

Over the past 20 years, global markets have become increasingly integrated, with enormous amounts of capital flowing across borders every day and emerging economies gaining an increasing share of international trade.[4]

In the aftermath of the emerging markets financial crisis in the late 1990s, many emerging market governments followed fixed or managed exchange rate regimes and built up large foreign exchange reserves. This, in combination with traditionally high private saving rates and a sustained rise in commodity prices, resulted in large net foreign exchange positions in these countries. A large proportion of these were invested in developed countries' government bonds and private debt instruments, financing substantial current account deficits in developed economies, especially the US. Together, these cross-border investment flows helped to push global long-term interest rates lower.

In addition, improved domestic macroeconomic policy frameworks and increased supply of low-cost goods from emerging markets reduced consumer price inflation and lowered longer term inflation expectations, contributing further to a low long-term interest rate environment. The result was low government bond yields and low returns on fixed income financial assets across all advanced economies.

With returns on conventional fixed-income assets low, and against a stable macroeconomic environment, investors sought higher returns by taking on more risk – both in terms of the products they created and invested in, and by increasing exposure to these instruments through higher levels of borrowing. This pushed down spreads on riskier assets to historically low levels, both between countries and between corporate borrowers.

The same period saw some very rapid financial innovation, which created methods of financing which allowed the imbalances to persist, and also created vulnerabilities that were not well understood. As is discussed throughout this chapter, it is this lack of understanding – and the behaviours of market participants and regulators which flowed from it – which policy-makers, regulators, and markets around the world need to address.

System-wide risks

3.23 A distinguishing feature of this crisis has been that the whole financial system came to be at risk. Economists refer to such risk as system-wide or systemic risk. This is an important area of Government intervention, because private market participants cannot manage systemic risk on their own once it arises. Indeed, in such circumstances their actions are motivated by self-preservation, and can have the adverse effect of making the system as a whole less stable.[5]

3.24 Financial research in recent years tended to suggest that greater integration implied more diversification, more risk-sharing and less vulnerability. Global regulatory standards have largely been set on the basis that as long as each financial institution was sound then the system overall would also be sound. Yet both these approaches underestimated the extent of systemic risk and the implications for system-wide risk of innovations in financial markets. Indeed, it appears that eagerness to extend the benefits of diversification, for example through expansion in the use of

[5] Moreover, the cost of any one financial institution's failure is potentially much greater than the cost to that bank's shareholders, because the failure can threaten the rest of the financial system and the economy more generally. Therefore a firm's managers and shareholders will not provide enough resources to ensure its success, leading to an inappropriately high level of exposure to systemic risk.

securitisation markets and derivatives products, may have inadvertently lead to an increase in systemic risk by creating an increasingly complex network of interconnections between firms.[6]

3.25 Globally, there was an under-appreciation of the significant increases in systemic risk building up across financial markets and over time. In particular, two important aspects of systemic risk need to be addressed in the reform of financial markets – systemic risk which arises from linkages across different financial markets, and the build up of systemic risk which arises through the tendency for risk taking and leverage in financial markets to increase in good times. The Government's strategy proposes new mechanisms to ensure that the authorities work better together to identify and take action to address systemic risk, now and in the future, in the UK and internationally.

Systemic risk across financial markets

3.26 Finance is essentially trade in promises to repay in the future. This is an inherently risky business as at the date when the promise matures there may be insufficient resources for repayment.

3.27 The risk that a single bank or institution may fail or a borrower default is known as idiosyncratic risk. Systemic risk, by contrast, arises because firms are exposed to common risks and their responses to market-wide shocks may have negative spillover effects onto other market participants. For example, if key asset markets become illiquid, then risks can quickly spread across many institutions. This can threaten the solvency of the entire financial system and in turn adversely affect the wider economy through self-reinforcing downward spirals.

3.28 Global regulatory standards around the world have primarily focused on firm-by-firm regulation. But, during the crisis, particular issues have arisen because:

- the complex and opaque network of counterparty exposures between firms resulted in investors' inability to discern sound from vulnerable institutions;
- similar balance sheet exposures of many financial institutions resulted in common responses by firms to market-wide shocks, which amplified the initial shock; and
- increased systemic risk which has arisen outside the perimeter of direct prudential regulation, such as in structured investment vehicles (SIVs) and other off-balance sheet financing vehicles of banks.

Counterparty exposures

3.29 Regulators and market participants have generally assumed that greater spreading of risk between individuals and institutions, both within and across borders, should increase the capacity of the economy as a whole to bear risk. However, the crisis has shown that, if this is not properly managed, it can result in an increase in the complexity of counterparty exposures between institutions and can make it more difficult to identify the extent to which firms are exposed to risk.

3.30 Because financial market participants are highly interconnected, a comprehensive assessment of the risks of entering into a contract with a firm requires information about all of the firm's counterparties, all of its counterparties' counterparties, and so on. Firms can therefore never have access to complete information on which to assess the counterparty risks to which they are ultimately exposing themselves when entering into a transaction. This has two important implications for counterparty risk management:

[6] See for example *The crisis of 2008: structural lessons for and from economics*, Daron Acemoglu, 2009

- in stable financial markets facing only firm- or product-specific shocks, firms will not take fully into account the potential spillover effects of the failure of a counterparty on the rest of the financial system; and
- by contrast, when financial markets face broader shocks market participants may over-compensate by, for example, ceasing to lend to counterparties who are in fact creditworthy.

3.31 The first of these factors means that market discipline will not be enough on its own to ensure that systemic risk is effectively managed. The second means that a shock that affects one, or a group of firms, can generate heightened market uncertainty, such as retail or wholesale runs on distressed institutions (as in the case of Bear Stearns in the US), and potentially on other institutions perceived to be heavily exposed to them.

3.32 The short-term impact of key markets dislocating may therefore be considerably greater than proves to be warranted, creating far greater losses and an inefficient economic outcome.

3.33 Financial innovations over recent years, such as the growth of the securitisation markets and the rapid expansion in the use of credit default swaps[7] (CDS) to transfer risk have increased the complexity and scale of the network of inter-relationships between financial institutions.

Firms' vulnerability to market illiquidity

3.34 The default of one financial institution imposes losses on other banks that have lent to it. If these losses are large enough, such an event could cause creditor banks to fail, and precipitate a systemic banking crisis through a "domino" effect.

3.35 However, the recent crisis has revealed that the direct impact of financial institution defaults may have by and large been of far less importance in precipitating or exacerbating the crisis than have the impact on firms of market shocks, in particular:

- liquidity shocks in key funding markets; and
- the impact on banks' balance sheets of falls in market prices.

3.36 The actions of individual institutions in response to a market shock can create significant impact on other firms. The purpose of securitisation is to repackage rules to investors better able to manage them. The consensus before the crisis – shared by the banking industry but also supervisors – was that the originate and distribute model of banking resulted in risk being diversified and distributed more widely across the global financial system, reducing the total of individual risks to the economy.[8] Yet banks held large inventories in their trading books and so suffered huge losses. As they all tried to sell similar assets together, liquidity dried-up, making values even lower.

3.37 Developments in financial markets over the last two decades have arguably made the financial system more vulnerable to market shocks. Finance has become increasingly market-based, and banks have become more dependent for their financing on continued liquidity in securitisation and other wholesale funding markets. The sensitivity of market prices to information when there is the realistic risk of default has made many of these markets altogether less robust.

[7] CDS transactions allow one party to purchase protection from another against the possible default of a (third) company. One party, the protection buyer, pays a premium or series of periodic payments to another, the protection seller, to protect against the loss that may be incurred by a credit event related to an underlying asset or its debtor.

[8] For example, in 2006 the IMF argued that: "...based on the data available, there is no evidence of increased credit concentrations among regulated entities, such as smaller or regional banks, insurance companies, pension funds, or mutual funds, as a result of these risk transfer markets. As such, future credit losses are likely to be more broadly distributed, and individual losses less likely to cause a policy concern for a particular sector". *Global Financial Stability Report*, International Monetary Fund, April 2006, p.76.

Scope of regulation

3.38 The combination of financial deregulation and information technology has led to a vast increase in financial innovation over the last two decades. Many innovations have increased the ability of banks to offset risks and pass on lower costs to consumers. However, the crisis has shown that regulators and central banks around the world failed to understand the full implications of financial innovations for systemic risk.

3.39 One of the greatest challenges for financial regulation is that markets are always evolving, including changing in response to the regulatory environment.[9] Regulation has traditionally focused heavily on consumer protection, so banks that take retail deposits have tended to be subject to stricter regulation than other bank-like institutions, which carry out maturity transformation, but which do not deal directly with retail customers. This in turn has encouraged banks to innovate to avoid the regulatory reach of the authorities.

3.40 Institutions and activities have developed outside the boundaries of direct prudential regulation which proved sufficiently large and inter-connected to pose systemic risks. Regulated banks, for example, built up large exposures to structured investment vehicles (SIVs) that were treated as off-balance sheet (thus outside the regulatory boundary for the purposes of setting bank capital), but which in many cases were forced back on to banks' balance sheets when wholesale funding markets' liquidity dried up.

Understanding and managing pro-cyclicality

3.41 Systemic risks also build up over time. In an upturn, banks may feel more confident and excessively ease credit conditions, adding to the size of the economic cycle. In a downturn, the converse can happen. This co-movement between credit conditions and the economic cycle is termed as "pro-cyclicality", as it results in an amplification of the cycle.

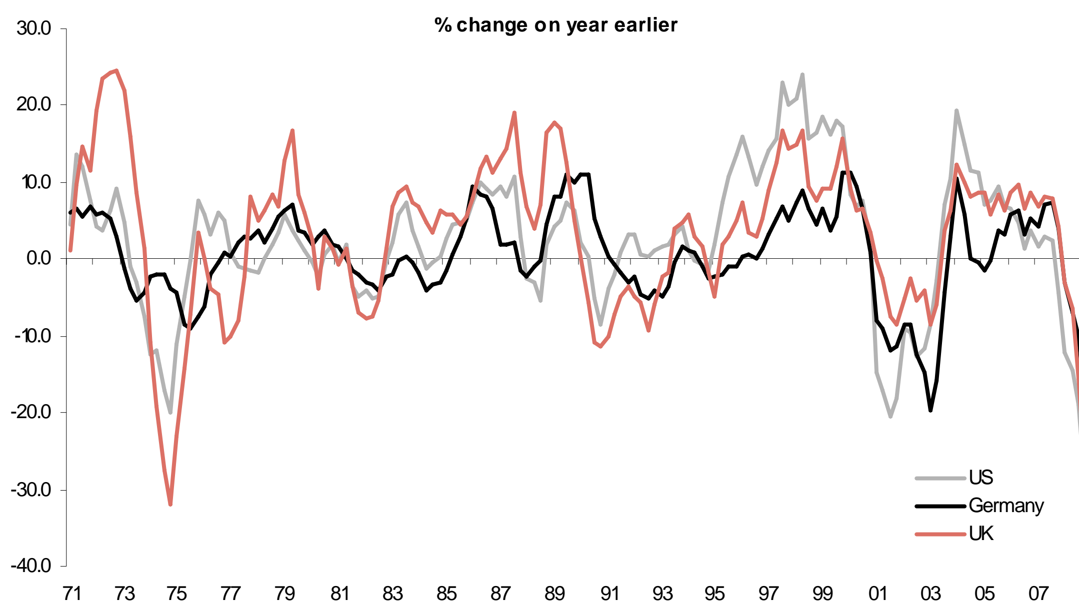
3.42 The pro-cyclical nature of risk-taking in financial markets can result in financial institutions becoming over-leveraged and over-extended during good times, making markets as a whole more vulnerable to a shock or a change in sentiment.

3.43 In these circumstances, if markets are destabilised the economic costs will be particularly severe as financial institutions cut back on lending and households and businesses are forced to deleverage and are hit by rapid falls in asset prices. As asset prices decline this can create a sharp deterioration in private sector net worth, eventually resulting in financial distress.

3.44 The feedback loops between financial markets and the real economy have been particularly evident recently, with the decisions by some banks to cut lending in order to deleverage exacerbating the economic downturn and in turn worsening prospects for the banks themselves.

[9] *The credit crisis: conjectures about causes and remedies (NBER Working Paper No. 14739)*, Douglas Diamond and Raghuram Rajan, February 2009 (available from www.nber.org)

Chart 1: Real asset prices*



**Includes equities, residential housing and commercial property prices, deflated by personal consumption deflators. Source: BIS*

Causes of financial markets' pro-cyclicality

3.45 A recent report by the Financial Stability Forum[10] argues that, looked at from the point of view of market failures, key causes of pro-cyclicality include:

- limitations in the measurement of risk: risk tends to be measured on the basis of short periods of historical data, and so will tend to fall during periods of expansion as risks are building up and then increase sharply when the cycle turns. Moreover, the use by market participants of similar risk models may reinforce these inherent tendencies towards herding in financial markets; and
- distortions in incentives: in particular, incentive problems created by financial institutions' remuneration structures have been identified as a key contributor to excessive risk-taking during financial markets expansions.

3.46 In addition, markets can be prone to collective action problems, which can result for example in asset prices deviating from their fundamental values because it is not in the rational self-interest of individual market participants to bet against the market for a long period. This can magnify pro-cyclical developments.

Impact of financial innovations

3.47 Financial innovations in recent years may have made the financial system more prone to pro-cyclicality for a number of reasons:

- the use by banks and other financial institutions of VAR models, which use the volatility of the price of the asset over the recent past in order to quantify the risk

[10] *Report of the Financial Stability Forum on addressing procyclicality in the financial system*, Financial Stability Forum, April 2009 (available from www.financialstabilityboard.org)

entailed in marketable securities, appears to have exacerbated the tendency for financial markets to under-price risk in good times; and

- the use by market participants of market-based mechanisms to manage counterparty risk, which are based on near-horizon estimates of risk and do not 'see through the cycle', may also reinforce pro-cyclicality.

Lack of transparency of banks' balance sheets

3.48 The use of capital by banks is frequently pro-cyclical, mirroring fluctuations in the perceived riskiness of lending. In cyclical upturns the returns to lending are seen as high so banks often run down capital to increase their loan and asset books, whereas in a downturn, when risks rise, they typically look to retain capital, driven in particular by market pressure.

3.49 This pro-cyclicality of bank capital is exacerbated by a lack of transparency of banks' balance sheets. When banks face losses and seek to raise new capital this can be seen as a signal that banks are hiding even greater losses, causing investors to be reluctant to provide banks with funds. This pushes up the cost of capital and in the extreme can make it impossible for banks to issue new equity.[11] This increases pressure on banks to deleverage rapidly and cut back on new lending in order to avoid violating any regulatory or market-imposed minimum capital ratios.

Impact of regulation on pro-cyclicality

3.50 It has also been argued that some aspects of the current regulatory and financial reporting frameworks are pro-cyclical:

- regulatory capital: while Basel II marks an improvement over Basel I in many respects, concerns have been raised that risk-sensitive Basel II regulatory capital requirements have increased pro-cyclical behaviour. The Basel II regime aims to tie regulatory capital requirements more closely to risks than was the case under the preceding regime. Banks will use either credit rating agency assessments or their own internal risk models to calculate risk weightings. These credit quality assessments tend to fluctuate with the cycle and, in particular, as mentioned above markets frequently systematically underestimate risk in good times;

- accounting standards: concerns have also been raised that fair value accounting may contribute to pro-cyclical behaviour by financial institutions. The present accounting standards use a mix of adjusted historical and current costs, but over the past 20 years or so the trend has been towards increasing use of market-based values because investors have considered these more useful in understanding current performance and value. However, reporting at market-based values may increase pro-cyclicality by encouraging excessive risk-taking or risk-shedding activity in response to observed changes in asset prices, unless investors and supervisors recognise this tendency; and

- moral hazard: governments around the world have taken action to provide support to the financial sector as a whole, while central banks have cut interest rates heavily, increased the range of collateral accepted in open market operations and increasingly turned to unconventional monetary policy instruments to provide liquidity to the financial system. There is a risk that such actions create a presumption that the official sector will take whatever action necessary to bail out

[11] "Corporate financing and investment decisions when firms have information that investors do not have", N Majluf and S Myers in *Journal of Financial Economics*, 1984

the financial sector in bad times, encouraging the markets collectively to take more risk and extend more credit in good times.

Tackling the core problems of the crisis

3.51 The analysis above of the causes of the financial crisis highlights a number of core problems which must be resolved if the global reform agenda is to lead to a return to fair, efficient and stable financial markets around the world, which can play their part in supporting economic growth and prosperity.

3.52 The Government's strategy for reform will, therefore, focus on resolving the following problems, each of which are addressed in one of the next four chapters:

- first, strengthening the UK's regulatory institutional framework, so that it is better equipped to deal with the issues raised by globally interconnected markets and firms;
- second, dealing with high impact firms that may be seen as being "too big to fail", through improved market discipline; and through improved supervisory focus on such firms;
- third, identifying and managing systemic risk as it arises across different financial markets and over time; and
- fourth, working closely with international partners to deliver the global action required to respond to the lessons of the financial crisis.

3.53 Finally, it is also clear that the global financial crisis has led to a disconnection between financial services providers and their consumers, particularly ordinary individuals and small businesses relying on their banks for the provision of essential day-to-day services. One important manifestation of this disconnection is in the extent to which public trust in financial markets has been eroded.

3.54 There is an important sense, therefore, in which financial services and markets have to be reconnected with these core consumers. This is a further challenge for the Government's reform programme: making financial services work for consumers once more, and in doing so seeing what more can be done to strengthen competition and choice in the UK financial markets. This issue is dealt with in the penultimate and final chapters (Chapters 8 and 9).

Summary

3.55 This chapter has set out our analysis of the financial crisis, and explained how it is informing the Government's actions to reform financial regulation in the UK and internationally. The next chapter will outline the Government's reforms designed to strengthen the objectives, powers and governance arrangements of the FSA and the Bank and make cooperation and coordination between these institutions and the Treasury more formal and transparent.

4 Strengthening regulatory institutions

Well-designed, appropriate and clear institutional arrangements are a key element of a healthy and effective regulatory system.

This chapter sets out the Government's proposed changes to the governance, coordination and regulatory framework of the UK's financial authorities in order to prepare and equip them to effectively regulate the financial sector in the future, including the implementation of a more systemic or macro-prudential approach to regulation.

The Government intends to:

- legislate to create a new formal Council for Financial Stability to analyse emerging risks to the financial stability of the UK's economy and coordinate the appropriate response;
- strengthen the objectives and governance arrangements of the FSA, in line with the reforms to the Bank of England's governance structures and financial stability remit set out in the Banking Act 2009; and
- enhance the FSA's regulatory powers to support its new and strengthened systemic approach to regulatory supervision, which will include:
  - strengthening the FSA's powers to take action in relation to firms and individuals which are guilty of misconduct;
  - establishing stand-alone powers for the FSA to take emergency action to place restrictions on short selling and to require disclosure of short selling;
  - examining the need to extend the FSA's information-gathering powers.

Introduction

4.1 Previous chapters have discussed the causes of the financial crisis and the core problems that need to be tackled to strengthen financial regulation. The increasing complexity and the global nature of financial services and the high levels of innovation in financial products, institutions and markets are making the task of financial regulators across the world progressively more difficult.

4.2 Greater focus on systemic issues, and the links between supervisory policy and macroeconomic policy, will require even greater joint-working and information-sharing between regulatory authorities.

4.3 In the UK, monetary policy decision-making is the responsibility of one committee, normally operating a single principal lever in pursuit of a quantitatively defined inflation target. By contrast, financial stability cannot be defined in any simple or straightforward manner; no single indicator can capture it; the actions of many players (in both the official and private sectors) have a major bearing on it and a wide range of policy instruments can be (and must be)

deployed to deliver stability and prevent instability. Financial instability can also have major fiscal consequences. Consequently in the UK – as in every other developed country – responsibility for delivering financial stability is shared between the regulator, the central bank and the finance and economics ministry. This is true whatever the precise institutional framework.

4.4 Macroeconomic conditions can have a major impact on the financial sector, and vice versa, with instability in either having implications for the other. Successful policy therefore requires a high degree of coordination and cooperation between the authorities, so that the links between macroeconomic and financial conditions (and the policies affecting them) are properly understood and considered (this is sometimes described as the 'macro-prudential' approach).

4.5 Well-designed, appropriate and clear institutional arrangements are a necessary – but not sufficient – element of a healthy and effective regulatory system. While it is important to define clearly where responsibility and accountability lies to avoid gaps in regulation, it is equally important to avoid unnecessary overlaps and duplication.

4.6 The Government believes that the UK's current model of a single regulator for the financial services sector remains appropriate. But the Government is committed to ensuring that the UK's institutional framework can deal with the core issues identified in this paper and effectively regulate the financial sector in the future. With this aim, the Government will formalise the arrangements for institutional cooperation in financial stability and strengthen the governance arrangements, objectives and powers of the FSA, in line with the reforms to the Bank of England's governance structures and financial stability remit set out in the Banking Act 2009.

Formalising and strengthening the arrangements for institutional cooperation

A new Council for Financial Stability

4.7 At present, a Standing Committee of the Treasury, the Bank of England and the FSA, established under a Memorandum of Understanding, serves as a forum for discussion and coordination of the activities of the authorities to protect financial stability.[1]

4.8 The Standing Committee has played a key role in coordinating the authorities' response to the crisis. Meetings of the Chancellor of the Exchequer, the Governor of the Bank of England and the Chairman of the FSA have guided and coordinated overall strategy. And at times – for example during planning for the resolution of individual institutions or in the run-up to the October 2008 recapitalisation – the Standing Committee met at official level on a daily basis.

4.9 The Government believes that this cooperative framework can be enhanced through a more formal structure, with regular meetings, greater transparency over proceedings, as well as a clear line of accountability to Parliament.

4.10 The Government intends to legislate to create a new statutory committee – the Council for Financial Stability (CFS) – which will replace the Standing Committee. The Council will consist of the Treasury, the Bank of England and the FSA and will be chaired by the Chancellor of the Exchequer.

4.11 The objectives of the new Council will be to analyse and examine emerging risks to the financial stability of the UK's economy, and coordinate the appropriate response. The CFS will have regular meetings throughout the year, to discuss the authorities' assessment of systemic risk and to consider what action is needed. The Council will consider key publications – for

[1] *Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority*, March 2006 (available from www.hm-treasury.gov.uk, www.bankofengland.co.uk, www.fsa.gov.uk)

example the Bank of England's six-monthly Financial Stability Report (FSR), and the FSA's annual Financial Risk Outlook (FRO) – to inform its deliberations.

4.12 The CFS will also meet as necessary to discuss particular risks to financial stability, involving specific sectors or firms, and to coordinate any regulatory action or intervention required.

4.13 To increase public transparency and accountability, minutes of the standing meetings of the CFS will be published. The confidentiality of market-sensitive discussions will, of course, be protected, and it is likely that this will mean that a significant proportion of the Council's minutes will not be suitable for publication.

4.14 The reports considered by the CFS should feed directly into effective supervisory and regulatory action. For example, the Government believes that the FSR and FRO, in addition to identifying risks to the UK financial system, should also consider and discuss different actions that could be undertaken to address them, including an analysis of each possible intervention and a recommended course of action. Furthermore, as set out in Chapter 5, the Government has agreed with the FSA that it will report annually on remuneration practices, including compliance with the FSA's new code, emerging risks to financial stability, and any action that needs to be taken. The question of remuneration will be considered at the first meeting of the CFS.

4.15 The CFS will take steps to ensure that it communicates effectively with the market. For example, the Council may agree to distribute reports to independent directors of regulated institutions so that issues raised are given the widest possible hearing. The FSA may want to consider asking relevant regulated institutions to set out how they are addressing the risks that have been identified.

4.16 An annual report will be published and provided to Parliament, setting out in full the activities of the CFS. It will describe significant regulatory actions (for example those taken under the Banking Act 2009 and FSMA), including potential further developments to regulatory legislation (such as the scope of regulation). The CFS will consider the report prior to publication.

4.17 Since the onset of the crisis the Government, the Bank of England and the FSA have worked closely together to pursue reforms to strengthen EU and international regulation and enhance cross-border cooperation. The Treasury, Bank of England and FSA will need to continue to collaborate closely in pursuing the UK's interests, both in key international regulatory bodies, such as the FSB and the Basel Committee, and in the EU.

4.18 To this end, the Government proposes that an additional role of the CFS will be to discuss and coordinate the UK Authorities' position on EU and international financial stability and regulatory policy issues. As outlined below, the Government intends to give the FSA a duty to promote sound international regulation and supervision, which would complement the Government's and the Bank of England's objectives in this regard.

4.19 The Government will establish Terms of Reference for the new Council, which will replace the existing Memorandum of Understanding.

4.20 The membership of the CFS will be limited to the three authorities, but the Council will benefit from outside expertise via the external members of the governing bodies of the Bank and the FSA (in particular those members of the Bank's Court who also sit on the Bank's Financial Stability Committee). The members of these governing bodies approve the analysis and recommendations of their institutions in advance, and could, if appropriate, be invited by the Chancellor to participate in the meetings of the CFS.

Accountability to Parliament

4.21 The Government will also discuss mechanisms for increasing the democratic accountability of the CFS, given its role in public policy making and implementation, possibly through greater, Parliamentary scrutiny. The Government notes the important role that the Treasury Select Committee (TSC) has played throughout the events of the last two years in fulfilling this function. It is, of course, for the House of Commons to decide how the TSC may best fulfil its role. The Government will consult on options for broadening and strengthening channels of democratic accountability and will work with the TSC to consider whether and how emerging options should be implemented.

4.22 The Government also notes the recommendation of the Public Accounts Committee (PAC), in its recent report on Northern Rock that the FSA should in future be subject to oversight by the National Audit Office. The Government will consider this recommendation carefully, and report back to the PAC before the summer recess.

Strengthening the governance arrangements and statutory framework of the regulatory authorities

4.23 Recent events have shown the importance of good governance and accountability in financial firms and also among the public bodies responsible for dealing with the financial system. To augment the effectiveness of the new CFS, it will be important to ensure that the governance arrangements of each of the authorities remain strong and appropriate.

The Bank of England

4.24 The Bank of England's responsibility for financial stability was explicitly recognised in 1997, through the MoU with HM Treasury and the Bank of England. The Bank of England Act 1998 gave the Bank for the first time a statutory objective for monetary policy, though not for financial stability. The Banking Act 2009 put the Bank's non-statutory financial stability objectives onto a legislative footing.

4.25 The Banking Act 2009 also made a series of changes to the Bank of England's governance framework in order to:

- formalise the Bank's existing remit for financial stability, with the creation of a new statutory financial stability objective;
- establish a new Financial Stability Committee of Court, including external experts, to support the Bank in its enhanced role;
- modernise and streamline its governance arrangements, by creating a smaller, more focused Court of Directors, in line with modern corporate governance practice; and
- give the Bank important new powers and roles in relation to the use of a special resolution regime for failing banks and building societies.

Box 4.A: The Bank of England's Financial Stability Committee

Established on 1 June under the Banking Act 2009, the Financial Stability Committee (FSC) is a sub-committee of the Bank of England's Court of Directors – the Bank's governing body. The membership of the Committee comprises four non-executive directors of the Bank alongside both deputy governors (responsible for monetary policy and financial stability) and the Governor – who chairs the FSC.

The role of the Committee is to support the Bank in pursuit of its new statutory objective to "protect and enhance the stability of the financial systems of the United Kingdom".[2] This includes making recommendations to Court about the Bank's strategy in relation to financial stability and advising on the Bank's actions in respect of failed institutions in the special resolution regime. The FSC, its core executive presence balanced by a majority of non-executives, provides a single focus of financial expertise and the principal forum for financial stability matters within the Bank.

In addition to relying on the expert financial stability advice provided by the experienced non-executives on the Committee, the FSC can also co-opt additional members in order to utilise the widest possible range of external experience and expertise in supporting and advising on crucial decisions to safeguard the UK's financial stability.

The Financial Services Authority

4.26 Having reviewed and reformed the objectives and governance of the Bank of England in the Banking Act 2009, the Government now proposes to conduct a similar exercise for the FSA. In doing so, the Government's intention is to support greater focus on prudential supervision, enable greater attention to system-wide risks and establish explicit legal authority to take action to support financial stability. This will mean re-examining the FSA's statutory objectives and governance arrangements.

4.27 The FSA's existing objectives, as set out in FSMA, are:

- maintaining market confidence in the financial system;
- promoting public understanding of the financial system;
- securing the appropriate degree of protection for consumers; and
- combating financial crime.[3]

4.28 The FSA's rule-making and other powers are directly linked to the pursuit of these objectives, and their powers are more constrained in relation to some objectives than others.

4.29 The FSA currently has no specific objective for financial stability, although maintaining financial stability is a fundamental component of maintaining confidence in the financial system. The Government believes that to facilitate the FSA's new supervisory approach, the regulator's objectives should contain a more explicit recognition of the role of the FSA in maintaining and enhancing financial stability. The Government therefore intends to legislate to provide the FSA with an explicit financial stability objective, which will help to clarify that the FSA's regulatory and supervisory approach should include an enhanced focus on monitoring, assessing and mitigating systemic risks.

[2] See *Banking Act 2009*, section 238(1) 2A (available from www.opsi.gov.uk)

[3] See *Financial Services and Markets Act 2000*, section 2(2) (available from www.opsi.gov.uk)

4.30 In the UK, as in other countries, responsibility for financial stability is shared between the regulator, the central bank and the finance and economics ministry, each authority using the policy tools available to them and performing different, but complementary roles to support financial stability. The Banking Act 2009 amended the Bank of England Act 1998 to provide the Bank with a statutory objective for financial stability. This objective is "to contribute to protecting and enhancing the stability of the financial systems of the United Kingdom". The legislation also establishes that "in pursuing the financial stability objective, the Bank shall aim to work with other relevant bodies (including the Treasury and the Financial Services Authority)."

4.31 The introduction of a similar financial stability objective for the FSA would be consistent with the Bank's objective. And the new CFS will ensure that the cooperation and interaction between each institution's financial stability work is closely coordinated.

4.32 In the light of increased international focus on financial regulation, this objective will establish that the FSA should take into account the impact of wider European or global financial stability concerns in its regulatory and supervisory decisions. In addition, the Government intends to legislate to create an explicit duty for the FSA to have regard to the need to work internationally. This would bolster steps that have already been taken to establish roles between the UK authorities, ensure that the UK's interests are well represented in international negotiations and ensure that European and international aspects of financial stability are given sufficient attention.

4.33 In carrying out its functions, the FSA is also required to have regard to a number of matters, known as the "principles of good regulation" (set out in Box 4.B). These include the principle that the burdens of restrictions imposed by regulation should be proportionate to the benefits and the desirability of facilitating innovation and competition.

Box 4.B: The FSA's "Principles of good regulation"[4]

In discharging its general functions the Authority must have regard to:

- the need to use its resources in the most efficient and economic way
- the responsibilities of those who manage the affairs of authorised persons;
- the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;
- the desirability of facilitating innovation in connection with regulated activities;
- the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom;
- the need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions;
- the desirability of facilitating competition between those who are subject to any form of regulation by the Authority.

[4] See *Financial Services and Markets Act 2000*, section 2(3)

4.34 At present, the FSA is required to take into account the costs and benefits of any proposed action but it is not specifically required to consider the possible wider economic or fiscal costs of a decision not to act. In practice, this has meant that the focus of the FSA's cost-benefit analysis (CBA) has been determined by its current statutory objectives. As discussed above, at present the FSA's objectives are focussed on consumers; therefore the FSA has concentrated on the immediate impact on market confidence and the direct costs to consumers of financial services. The creation of a new financial stability objective will clearly allow the FSA to take a broader range of impacts and costs into account. The Government will also amend FSMA to explicitly make clear that the FSA should consider the wider economic and fiscal costs of a failure of an institution when deciding between different possible courses of regulatory action.

4.35 The Government also proposes to consider the FSA's formal accountability and governance. The FSA and the Government agree that the FSA's governance arrangements, especially its Board structure and workings, need to continue to provide strong internal challenge and maintain responsiveness to new risks.

4.36 FSMA requires a majority of FSA Board members to be non-executive. In addition to the Chairman and Chief Executive, there are currently two Managing Directors and eight non-executive members of the board. One of the non-executive members is Deputy Chairman and 'lead' non-executive. The non-executive directors check that the FSA operates efficiently and economically (as required by FSMA). They also oversee its mechanisms of financial control and set the pay of the executive members of the Board.

4.37 Initially, the role of the Chairman of the FSA was an executive one. In 2003 the Treasury decided to separate the role of Chairman into two roles: Chairman and Chief Executive. The decision to make the split was based on:

- the changed focus of the FSA's top-level executive from the creation of a single regulator to delivery of the FSA's statutory objectives;
- the FSA taking on more extensive responsibilities, including mortgage and general insurance regulation; and
- a desire to mirror more closely best practice in corporate governance.

4.38 Since then, the FSA has had both a Chief Executive and a non-executive Chair, allowing the Chair to focus on providing strategic leadership to the FSA and its Board, while the Chief Executive is in charge of the operational management of the regulator, with a particular focus on supervision.

4.39 The Treasury appoints the non-executive members of the FSA's Board following the principles for public appointments issued by the Commissioner for Public Appointments ('Nolan Principles'). This includes the public advertisement of vacancies. The FSA is accountable to Treasury Ministers and, through them, to Parliament.

4.40 The Board has carried out periodic self-assessments, but since 2003 there has not been any formal assessment of the appropriateness and robustness of the FSA's governance arrangements.

4.41 Therefore, the Government welcomes the intention of the Board of the FSA to conduct a review of its functions and modes of operation, to identify whether any significant changes are required beyond those that would be addressed in its regular reviews of Board effectiveness. The review will be completed and submitted to the Treasury before the end of the year.

Strengthening the FSA's prudential regulation and supervision

4.42 Regulation is the drawing up of rules governing firms, markets or activities, whereas supervision is the application and enforcement of those rules on individual firms. A key lesson of the crisis is the need to strengthen global systems and standards of regulation and supervision. G20 leaders agreed to take action to ensure that their domestic regulatory systems are strong and to build a stronger, more globally consistent supervisory and regulatory framework for the future financial sector. The UK authorities are working domestically and with international partners to achieve this aim.

4.43 In October 2008, in the context of continued and widespread disruption in financial markets, the Chancellor asked Lord Turner, the Chairman of the FSA, to make recommendations on the changes in regulation and supervisory approach needed to create a more robust global banking system for the future. Lord Turner published his review and an accompanying FSA Discussion Paper on 18 March 2009. The Review set out 32 recommended actions to improve and strengthen financial regulation, including:

- strengthening prudential regulatory standards, and in particular improving the quantity, quality and international consistency of bank capital and strengthening liquidity risk management by financial institutions; and
- enhancing the FSA's supervisory approach.

Strengthening existing prudential standards of capital and liquidity

4.44 In addition to covering important areas discussed elsewhere in this strategy document – including options for tackling systemic risk and mitigating pro-cyclicality – the Review makes a number of recommendations in the areas of capital and liquidity to create a sounder global banking system. The UK authorities are working both domestically and internationally to ensure that these recommendations are incorporated into international prudential regulatory standards.

Capital

4.45 The Basel capital requirements set minimum levels of capital for banks and establish a level playing field, minimising the risk of cross-border capital arbitrage. Given the extent of losses suffered by many institutions during the financial disruption, it is evident that the level and quality of capital were calibrated too low to ensure the financial system could comfortably absorb losses of the scale seen.

4.46 The Government is working with EU partners to agree a common definition and level of high quality regulatory capital and ensure a more consistent adoption of the Basel standards. And work is already under way in the Basel Committee to strengthen capital requirements for trading books, which were calibrated too lightly. The FSA has proposed in the Turner Review a more fundamental review of trading book risk measurement and capital adequacy requirements. The Government fully supports this approach.

4.47 The ultimate increase in minimum capital requirements agreed will be the outcome of international discussion. It will depend on a number of factors and the need to take account of the range of regulatory changes being made. For example, the appropriate capital level depends in part on the effectiveness of the corporate governance regime and the standards of capital quality and liquidity. It will therefore be important to undertake thorough quantitative impact assessment when the nature of all the planned regulatory changes becomes clearer.

4.48 Capital quality is of equal importance to capital levels, which is why G20 leaders have asked the Basel Committee to take forward work in this area. High quality capital, and in particular shareholder equity, provides protection to depositors as it is available to absorb losses on a

going-concern basis (i.e. before a default). By contrast, lower quality capital, for example subordinated debt, cannot prevent the disruption to depositors and potentially to the financial system and the economy at large that the failure of a bank could cause. Therefore regulation differentiates between different types of capital. The Government believes that the focus of regulatory requirements should be on banks building buffers of high quality capital, which can be used to absorb losses, and in particular common equity capital.

4.49 While regulations stipulate minimum capital requirements, banks choose how much capital to hold subject to meeting this minimum. However, there is now a consensus that regulation should require banks to build counter-cyclical buffers of resources above regulatory minima in good times. This is discussed further in Chapter 6.

Liquidity

4.50 The financial crisis has also demonstrated the central role that liquidity shocks can have in financial crises. Liquidity management is central to the functioning of a banking system whose primary function involves maturity transformation. It is clear that a bank's liquidity position can be as important as its capital position in terms of its ability to survive extreme events in the financial system.

4.51 Liquidity is an area that has had less international attention than capital, but it is of equal importance. The Basel Committee has been asked by G20 leaders to develop and agree by 2010 a global framework for promoting stronger liquidity buffers at financial institutions, including cross-border institutions.

4.52 . The Government strongly supports more active international engagement in this area and looks forward to proposals for a higher, more globally consistent standard.

4.53 The FSA has published far-reaching proposals to reform liquidity standards in the UK,[5] consisting of more extensive information requirements, quantitative liquid asset buffers determined for each bank, a more comprehensive approach to stress testing including the consideration of market wide stresses and proposals relating specifically to cross border branches. The Government strongly supports this approach.

FSA's supervisory enhancement programme

4.54 In October 2007 the Chief Executive of the FSA asked its director of internal audit to carry out a review of the lessons learned from the supervision of Northern Rock during the period from 1 January 2005 to 9 August 2007.

4.55 The internal audit review[6], published on 26 March 2008, identified four key failings in the FSA's supervision of Northern Rock:

- a lack of sufficient supervisory engagement with the firm, in particular the failure of the supervisory team to follow up rigorously with the management of the firm on the business model vulnerability arising from changing market conditions;
- a lack of adequate oversight and review by FSA line management of the quality, intensity and rigour of the firm's supervision;
- inadequate specific resource directly supervising the firm; and

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[5] *Strengthening liquidity standards*, Financial Services Authority, December 2008 (available from www.fsa.gov.uk)

[6] *Executive summary of the FSA's internal audit review of its supervision of Northern Rock, and the FSA management response*, Financial Services Authority, March 2008 (available from www.fsa.gov.uk)

- a lack of intensity by the FSA in ensuring that all available risk information was properly utilised to inform its supervisory actions.

4.56 In response, the FSA implemented a supervisory enhancement programme (SEP), which includes a series of elements designed to improve and strengthen the FSA's supervisory approach.

4.57 Initially, the main features of the SEP – welcomed by the Government – were:

- a new group of supervisory specialists to review regularly the supervision of all high-impact firms to ensure procedures are rigorously adhered to;
- an increase in the numbers of supervisory staff engaged on high-impact firms, with a mandated minimum level of staffing for each firm;
- an expansion of the existing specialist prudential risk department of the FSA following its upgrading to divisional status, alongside an expansion in the resource of the relevant sector teams;
- improvements to the supervisory training and competency framework for FSA staff;
- an increased degree of FSA senior management involvement in direct supervision and contact with high-impact firms;
- more focus on liquidity, particularly in the supervision of high-impact retail firms; and
- heightened emphasis on assessing the competence of firms' senior management. [7]

4.58 When the Turner Review, at the instigation of the Chancellor, re-examined the FSA's past supervisory approach, it concluded that too much weight had been placed on:

- the supervision of individual institutions instead of the system as a whole;
- ensuring that systems and processes were correctly defined rather than on challenging business models and strategies;
- checking past conduct of approved persons instead of assessing their technical skills; and
- conduct of business regulation of the banking sector rather than prudential regulation of banking institutions.

4.59 The Review explained how the SEP would be extended and enhanced to put in place a more intrusive and systemic supervisory approach. Lord Turner describes the programme as part of the FSA's shift from focusing primarily on the regulation of individual institutions, to combining this with a strong focus on the overall system and on the management of systemic risks across the economic cycle.

4.60 The SEP's 'intensive supervision' includes:

- macro-prudential analysis, using sectoral and firm comparator analysis to help build an overall picture of macro-prudential risks, identify firms which are outliers in terms of risks and business strategies and identify emerging sector-wide trends which may create systemic risk;

[7] *Press release: FSA moves to enhance supervision in wake of Northern Rock*, Financial Services Authority, March 2008 (available from www.fsa.gov.uk)

- more intense contact with bank management and auditors in relation to published accounts and accounting judgements;
- a significant increase in the resources devoted to the supervision of high impact firms, especially high impact and complex banks;
- a shift in the approach to the assessment of approved persons, with a focus on technical skills as well as probity;
- investment in specialist skills, with supervisory teams able to draw on enhanced central expert resources; and
- a focus on remuneration policies, and the integration of oversight of remuneration policies into overall assessments of risk.

4.61 To further underpin these changes, and to ensure they are fully embedded into the institution, the FSA announced on 2 July a change to its organisational structure to align with its new functional model. These changes are designed to provide greater clarity to the way the FSA operates, and in particular to reinforce its role as prudential regulator, based on a model of integrated risk analysis and supervision. Implementation of this change will be effective on 1 October, to coincide with the completion of the supervisory reforms initiated through the SEP.

4.62 The Government supports the improvements set out by the FSA under its SEP and the expansion in regulatory analysis to cover macro-prudential risks. In addition, the Government welcomes the extensive benchmarking and testing of the FSA's intensive supervision against the supervisory approaches of other financial centres such as the US and Spain.[8] The Government will work with the FSA to consider the right approach to continuing to benchmark the FSA's progress, both against international comparators, and in terms of the objectives it has set itself within its supervisory enhancement programme.

Enhancing regulatory powers

4.63 The Government has already legislated, through the Banking Act 2009, to give the authorities broad new powers to intervene to prevent or resolve the likely failure of a bank or other deposit-taking institution. The new special resolution regime now represents global best practice, as seen in the speedy and successful resolution of the problems facing the Dunfermline Building Society. The measures implemented by the Banking Act are described in more detail below.

4.64 The Government will now go further, providing the FSA with new and strengthened powers to allow it to continue to play a major role in its area of responsibility in supporting financial stability, but with clearer freedom to act pre-emptively to prevent instability.

4.65 The Government is also ready to give the Bank or FSA, as appropriate, further powers to implement the new global standards that the G20 has called for. The Government has played a leading role in international efforts to identify new rules and policy instruments to help the authorities across the world smooth the impact of credit conditions on the business cycle more effectively. The London Summit of the G20 set out a broad programme of work, which the international standard-setting bodies are taking forward urgently. It is not yet clear what the conclusions will be but, as set out in Chapter 6, they could include counter-cyclical capital requirements, overall limits on leverage ratios, dynamic reserving or other measures to increase capital buffers (and slow the increase in credit expansion) during the upswing, to make the system more resilient and less prone to volatility.

[8] *A regulatory response to the global banking crisis*, Financial Services Authority, March 2009 (available from www.fsa.gov.uk)

Table 4.A: The Turner Review

Turner Review recommendations	Government response	Paragraph reference
Capital requirements (recommendations 1 and 2)	The Government agrees on the need to strengthen regulatory capital requirements and that in the next cycle the amount and quality of capital in the financial system will need to be increased. The Government agrees that capital required against trading book activities should be increased significantly. The Government supports work underway in the Basel Committee and at EU level to strengthen international and EU regulatory capital frameworks.	Chapter 4 4.44-4.49 Chapter 6 6.24-6.26
Pro-cyclicality (recommendations 3, 4, and 5)	The Government agrees that banks will need to build counter-cyclical buffers of resources above regulatory minima in good times. The UK supports the work in train through the Basel Committee to develop policies to mitigate pro-cyclicality in the financial system, as well as work in the EU. Building on the analysis in the Turner Review, the Government is working closely with the FSA and the Bank and in EU and international fora to develop these tools.	Chapter 3 3.41-3.50 Chapter 6 6.37-6.68 Chapter 7 7.6
Leverage ratios (recommendation 6)	The Government agrees that risk weighted capital requirements need to be supplemented with a leverage ratio. To this end, the Basel Committee is taking forward work to use leverage ratios as a supplement to risk-based capital requirements. The Government believes that any leverage ratio should be internationally comparable and include off-balance sheet items to reduce the risk of jurisdictional and regulatory arbitrage.	Chapter 6 6.41-6.43; 6.57
Liquidity and core funding ratio (recommendation 7)	The Government agrees on the importance of strengthening UK and international liquidity regulation. The UK is in the lead internationally on policy development on liquidity regulation. The FSA has published far reaching proposals to reform liquidity standards in UK banks, which the Government supports. This is also a priority for the UK through the G20. The Basel Committee has been asked by G20 leaders to develop and agree by 2010 a global framework for promoting stronger liquidity buffers at national and cross-border institutions	Chapter 4 4.50-4.53 Chapter 6 throughout
Coverage of regulation (recommendations 8 and 9)	The Government agrees that the setting of the regulatory perimeter should be determined according to the principle that financial activities should be regulated according to their economic substance and the risks they pose, not their legal form. The Government believes that enhanced focus by the FSA on systemic risk across financial markets requires greater information gathering and monitoring. The Banking Act 2009 extended these information-gathering powers to allow the FSA to collect information that is relevant to the stability of individual firms and financial stability as a whole. HM Treasury will ask the FSA to update it about relevant aspects of financial innovation, including areas where the FSA's scope of authority or existing powers are not sufficient for it to fulfil its statutory objectives. In response, the Government will give full consideration to any legislative changes that may be necessary.	Chapter 4 4.16 Chapter 5 5.25 Chapter 6 6.27-6.28
Offshore financial centres (recommendation 10)	The Government agrees with this recommendation. Last autumn, the Government commissioned the Independent Review of British Offshore Financial Centres to assess issues such as financial supervision and transparency, and financial stability. The UK is also working through the G20 and FSB to encourage a race to the top in regulatory standards for all significant financial services sectors.	Executive summary

Turner Review recommendations	Government response	Paragraph reference
Deposit guarantees (recommendations 11 and 12)	The Government agrees with both recommendations and notes that they have been or are being taken forward by the FSA. The Government will also write to the European Commission setting out views on strengthening EU deposit-guarantee arrangements.	Chapter 8 8.70-8.76
UK bank resolution (recommendation 13)	The Banking Act 2009 has put in place a permanent special resolution regime (SRR), which enables the Authorities to deal with failing banks and building societies.	Chapter 4 4.63
Credit Rating Agencies (recommendations 14, 15, and 16)	The Government agrees with these recommendations and has been working closely with the FSA and the Bank and with EU and international partners on these issues.	Chapter 7 7.4; 7.18; 7.21
Remuneration (recommendation 17)	The Government agrees with this recommendation and is pursuing the issue through the G20 and the FSB. The FSA published a draft code on remuneration practices in March 2009. The FSA will report back on its assessment of remuneration practices at the first meeting of the new CFS; and will continue to report annually.	Chapter 3 3.7-3.12 Chapter 4 4.14
Credit default swap market infrastructure (recommendation 18)	The Government agrees that derivatives, including credit default swaps, that are standardised, liquid and have price transparency should be cleared on a central counterparty.	Chapter 6 6.16
Macro-prudential analysis (recommendations 19 and 20)	The Government agrees that FSA and Bank should work collaboratively on macro-prudential issues and we have proposed the CFS to deliver that coordination in the UK. Given the global nature of financial markets, one country acting alone is unlikely to be effective. It is essential, therefore, that governments work together to coordinate the development of policy tools to mitigate risks from pro-cyclical behaviour in global financial markets.	Chapter 4 4.7-4.20 Chapter 6 6.37-6.40
FSA supervisory approach (recommendations 21 and 22)	The Government welcomes the FSA's proposals to implement its supervisory enhancement programme.	Chapter 4 4.62
Risk management and governance – Walker Review (recommendation 23)	The Government agrees that these are two areas which Sir David Walker should consider.	Chapter 3 3.10-3.13 Chapter 5 5.7-5.8
Narrow / utility banking vs. investment banking (recommendation 24)	The Government agrees with this recommendation and does not believe that Glass-Steagall style provisions, with artificial limits to firm breadth (or size), are appropriate. Instead, the Government believes that the best strategy for dealing with systemically significant institutions is through measures to strengthen market discipline; enhance prudential supervision, maintain stronger resolution arrangements; and improve the macro-prudential framework.	Chapter 5 throughout (Glass-Steagall 5.31-5.38)
Supervision of global cross-border banks (recommendations 25 and 26)	The Government agrees on the importance of enhanced international coordination on bank supervision, on the need for appropriate regulation of local subsidiaries, and supports the FSF's agreed principles for cross-border cooperation on crisis management and for the operation of supervisory colleges.	Chapter 7 7.27-7.32
European cross border banks (recommendations 27 and 28)	The Government agrees that we need more harmonised rules globally and in the EU. We agree that a fundamental review of the risks and safeguards around cross border branching models is needed.	Chapter 7 7.12-7.21; Box 7.A

4.66 With global financial markets and institutions, these measures can only be effective if implemented on a broad international basis, and it will be some time before consensus is reached. The Government is ready to take steps to implement such proposals in the UK, and to give the Bank or the FSA (as the case may be) the necessary tools to do so. But it would be premature to decide on the institutional responsibility for them until it is clear what the new tools are and how they are to be used.

Enhancing the FSA's powers

4.67 The Government is taking steps to ensure that the FSA's objectives and powers are designed in such a way that enables it to perform the extended role envisaged in the supervisory enhancement programme and the Turner Review effectively.

4.68 Section 138 of FSMA contains the power that allows the FSA to make rules – one of its main tools for regulating the financial sector. To complement the changes to the FSA's objectives, the Government proposes to amend this rule-making power so that it explicitly covers all the FSA's objectives, not just consumer protection. The current wording of section 138 allows the FSA to make rules that are "expedient", as well as "necessary", for consumer protection. This currently gives the FSA some discretion to make rules whose main purpose is, for example, financial stability, as this is likely to be held to be at least expedient for consumer protection. However, it has been argued that this discretion may not extend to rules made for wider economic reasons or to protect taxpayer interests. Therefore, the Government believes that it is prudent to amend the rule-making power to confirm that the FSA may, subject to the various checks and balances that already exist, make rules for the purpose of fulfilling any of their objectives and not solely in the interests of consumer protection.

4.69 In addition to the FSA's general rules, which apply to all firms or categories of firms, the FSA can also at its own initiative vary the permission it grants a firm ("OIVoP" or "Own Initiative Variation of Permission" powers, under section 45 of FSMA), and also has powers of intervention under section 194, which are designed for use on a more focused, case-by-case basis. The Government therefore similarly proposes to legislate to amend these sections of FSMA to ensure that the FSA may use its OIVoP and intervention powers for the purpose of fulfilling any of its objectives.

4.70 Strengthened analysis and a more systemic focus to regulation must be supported by proportionate but effective use of enforcement powers to deter and disrupt non-compliance by firms. To ensure that the FSA can successfully deliver the proposed agenda of enhanced supervision, there is also a need to consider whether the existing powers of the FSA are sufficient in all cases to support its regulatory activity.

4.71 FSMA provides the FSA with a broad suite of information-gathering and enforcement powers. These include the powers to direct firms to take action and to vary or remove the permission of firms to undertake specific action, as well as criminal sanctions in some cases. These powers already provide the FSA with the ability to take action to ensure delivery of its new supervisory approach.

4.72 However, as part of its process of continual review, the Government has identified three areas of FSMA that should be examined further and strengthened to ensure that the FSA can take appropriate action. These are enforcement powers in relation to authorised persons and firms; enforcement powers to prosecute market abuse; and extended information gathering powers.

Enforcement powers

4.73 The FSA has disciplinary powers in relation to both authorised and approved persons who are in breach of FSA rules or guilty of misconduct. Generally speaking, authorised persons are firms whereas approved persons are individuals approved by the FSA to carry out a controlled function within an authorised firm. By way of example:

- section 66 of FSMA enables the FSA to impose penalties on approved persons who are guilty of misconduct and to publish statements of their misconduct;
- where the FSA has granted permission (under Part 4 of FSMA) for an authorised person to carry out regulated activities, the FSA has power, in certain circumstances, to vary or cancel that permission; and
- the FSA also has a disciplinary power under section 206 of FSMA to impose penalties on authorised persons for contraventions of requirements imposed by or under FSMA or directly applicable EC Regulations made under the Markets in Financial Instruments Directive (MiFID).

4.74 To ensure that the FSA has all necessary tools, the Government proposes, within any limits set in EU law, to give the FSA:

- a power to suspend individuals or firms for misconduct; and
- a power to penalise individuals who perform a controlled function without the requisite FSA approval.

Market abuse sunset clauses and short-selling powers

4.75 Market abuse, and the regime to combat it, has been the subject of much debate in recent months, both in the UK and Europe. Ensuring that the UK has a robust framework for tackling market abuse continues to be a priority. Indeed, the Government is ensuring that the FSA has enhanced powers to prosecute market abuse through the forthcoming Coroners and Justice Bill.[9]

4.76 The UK currently has a wider definition of market abuse than many of its European counterparts – reflecting the regime that already existed in the UK prior to the implementation of the EU Market Abuse Directive (MAD). These 'superequivalent' elements of the UK's framework capture two additional categories of abusive behaviour:

- section 118(4) of FSMA captures misuse of information which does not meet the tests for disclosure to the market but which it is nevertheless considered abusive to deal on; and
- section 118(8) of FSMA captures behaviour that is likely to give rise to a false or misleading impression or to market distortion and is likely to be regarded by a regular user as a failure to observe expected standards.

4.77 There were mixed views as to the merits of a 'superequivalent' regime when the MAD was introduced and so these elements were made subject to a sunset clause with an original expiry date of 30 June 2008 unless they were extended. The Treasury consulted on whether or not to retain these provisions in February 2008. As the views on the merits of retaining this regime remained mixed, and there was a forthcoming EU review of the MAD, it was considered appropriate to extend the sunset clauses until 31 December 2009, by which time it was expected that the outcome of the EU review would be known and the UK would align its regime with the rest of Europe. This would help minimise transition costs for industry.

[9] See information on the Coroners and Justice Bill from the Ministry of Justice (available from www.justice.gov.uk)

4.78 Two matters have now arisen which affect further thinking on this:

- the EU review has been delayed and the European Commission only launched its call for evidence on the operation of the MAD in April of this year; and
- more importantly, the FSA used section 118(8) of FSMA in order to introduce emergency short-selling restrictions in the autumn of 2008.

4.79 The Government believes that it is important that the UK retain these 'superequivalent' provisions to allow the FSA to continue to have the ability to impose such emergency restrictions until broader independent powers are granted to the FSA to do so (see below). The Government therefore intends to extend the sunset clauses until 31 December 2011, via statutory instrument, before their expiry at the end of this year. It remains the Government's intention that the UK fully align with the EU regime in this area in due course – if the review of the MAD provides satisfactory solutions in both maintaining a robust UK regime and minimising cross-border costs for UK companies.

4.80 As noted above, the Government proposes to amend FSMA so that the FSA's powers to take such emergency action to place restrictions on short selling and require disclosure of short selling are independent of their powers in relation to market abuse. Legislating on this specific issue clarifies the landscape for firms and ensures that, whether or not the EU market abuse regime changes, the FSA will retain this power.

4.81 This approach also recognises that the dangers of disorderly markets and risks to financial stability may arise from circumstances that are not capable of classification as market abuse, and gives the FSA more flexibility in the use of its powers.

4.82 In parallel, the Government will provide the FSA with the appropriate powers to make rules regarding a permanent disclosure regime for short positions in UK stocks.

4.83 Disclosure standards for short selling are the focus of international initiatives in the International Organization of Securities Commissions (IOSCO) and the Committee of European Securities Regulators (CESR). Decisions have yet to be taken about what standards will apply, but having these specific separate powers will allow the UK to implement any EU and G20 global standards that are agreed.

Extended information powers

4.84 Enhanced focus by the FSA on systemic risk across financial markets will require greater information gathering and monitoring. The FSA will need to increase its focus on understanding the nature of the inter-relationships between firms, and on proactively identifying systemic vulnerabilities.

4.85 The Government will work with the FSA to look carefully at its powers and duties and, in the light of this, assess whether it is necessary for the FSA to have any additional or extended information-gathering powers. In particular, the Government will consider whether there are additional participants in the financial markets from whom the FSA may need to require information in order to carry out effective financial stability or macro-prudential analysis, which are not covered by the FSA's existing powers. This could also help inform the FSA of developments in financial innovation, including those outside the regulatory perimeter.

4.86 The Government is also considering whether additional provisions are needed to ensure that the Bank of England has access to the information it needs to fulfil its responsibilities for financial stability.

The Banking Act 2009

4.87 The Banking Act received Royal Assent in February this year. It provides the authorities, notably the Bank of England, with a suite of new and strengthened powers to safeguard the UK's financial stability. Key features of the Act relate to preventing failure, resolving failing institutions and improving the framework for compensation.

Preventing failure

4.88 The Act strengthens the authorities' ability to reduce the likelihood of bank failure by:

- setting down a statutory financial stability role for the Bank of England;
- establishing the new Financial Stability Committee of the Court of the Bank;
- improving arrangements for the provision of liquidity assistance by the Authorities;
- formally regulating inter-bank payments systems;
- requiring and empowering the FSA to collect information that is relevant to the stability of individual firms and financial stability as a whole; and
- establishing gateways for this information to be disseminated to the Bank of England and the Treasury.

Resolving failing institutions

4.89 The centrepiece of the Act is a permanent and proportionate special resolution regime, providing the authorities with a range of tools to deal with banks and building societies that are failing. These include:

- a power to facilitate private sector purchase;
- powers to transfer some or all of a bank to a bridge bank owned and controlled by the Bank of England;
- the ability to take a bank into temporary public ownership; and
- new insolvency and administration procedures for banks and building societies, and powers to introduce a new insolvency regime for investment banks, which will be provided for in secondary legislation early in 2010, if necessary.

Strengthening the framework for compensation

4.90 The Act sets out measures to improve the legal framework and efficiency of the FSCS, and measures to allow for the use of the National Loans Fund to provide the FSCS with immediate liquidity; a power to pre-fund the FSCS in the future; and measures to further protect holders of banknotes issued by commercial banks in Scotland and Northern Ireland. The following section considers further changes to the remit and governance of the FSCS.

Box 4.C: The SRR in action: Dunfermline Building Society

At the beginning of 2009 the Dunfermline Building Society had 34 branches, employed around 500 people, and had around 300,000 members, making it the twelfth largest building society in Britain.

In the run up to March 2009, there was a significant deterioration in the Dunfermline's financial position. Its problems were caused by a range of circumstances, including substantial loss-making commercial property lending, the purchase of over £150m of high-risk mortgage portfolios and the need to write off £10m from the purchase of a £31m IT system. These factors contributed to the society making a significant loss in the context of the society's size and historic profitability.

On Saturday 28 March 2009, the FSA determined that Dunfermline was likely to fail to meet the threshold conditions necessary for it to remain open for business, and that it was not reasonably likely that action could be taken by the society to enable it to satisfy these conditions.

Following this decision, the authorities sought a long-term solution for the Dunfermline Building Society, consistent with the statutory resolution objectives including: protection of Dunfermline's depositors; protection of public funds; and preservation of financial stability. It was therefore decided, following an auction conducted by the Bank of England over the weekend of 28-29 March, that core parts of the Dunfermline would be transferred to the Nationwide Building Society.

In consultation with the Treasury and the FSA, the Bank of England therefore exercised its powers under the Banking Act 2009:

- Dunfermline's retail and wholesale deposits, its 34 branches, head office and originated residential mortgages (other than social housing loans and related deposits) were transferred to the Nationwide Building Society.

- Dunfermline's social housing portfolio was placed into a bridge bank wholly owned by the Bank of England. Since then, Nationwide has also acquired the assets and liabilities held by the bridge bank, following a competitive auction process.

- A court order was made to place the remainder of Dunfermline's business into the newly created Building Society Special Administration Procedure. This part of the business included commercial loans, acquired residential mortgages, subordinated debt and most of Dunfermline's treasury assets.

Dunfermline's deposit business continues to operate normally, branches and telephone banking continue to be open and customers can access their account in the usual way. Loan and mortgage customers can continue to contact the Dunfermline and to make repayments as normal. All of the Dunfermline Building Society's staff have been transferred to Nationwide.

The Financial Services Compensation Scheme

4.91 The Financial Services Compensation Scheme (FSCS) plays a key part in protecting depositors with UK banks and customers of other parts of the UK financial services industry. The FSCS is the UK's statutory fund of last resort for customers of financial services firms authorised by the Financial Services Authority under FSMA. The FSCS can pay compensation up to the limits in the scheme rules to eligible claimants if a financial services firm is in default.

4.92 The TSC in its recent report on the banking crisis acknowledged the important role of the FSCS in meeting recent challenges.[10] And the 2009 Budget recognised the new challenges that have arisen, and will continue to arise, for the FSCS.

4.93 The FSA has made a number of changes to the scheme over the last two years to improve the framework for compensation in light of the lessons learned during the global financial crisis. Furthermore, the Banking Act 2009 brought in measures to improve the scheme's legal framework and facilitate operational improvements.

Expanding the FSCS remit

4.94 The FSCS played an important role in ensuring financial stability and protecting depositors during the bank resolutions of 2008. In a number of cases, the FSCS had to go beyond its formal remit under the FSMA to pay compensation to individual claimants under the scheme in accordance with the scheme rules made by the FSA. In particular, the FSCS arranged for the payment of full compensation to retail depositors with the UK branch of the Icelandic bank Landsbanki (Icesave) and with the UK bank London Scottish, which were in default. These payments included not just the compensation which the FSCS was due to pay under the scheme rules, but also the compensation due to Icesave depositors from the Icelandic deposit-guarantee scheme, and the amounts the Government provided to ensure that all retail depositors in Icesave and London Scottish were fully compensated.

4.95 The Government believes these events show that the FSCS can operate effectively outside its narrow formal remit, by acting as an agent to deliver compensation to UK customers of financial services firms, including by:

- acting as the single point of contact (see below) in the UK for deposit-guarantee schemes in other Member States;
- acting as the UK agent for compensation schemes in other countries (including third countries) when they have to pay compensation to UK customers; and
- acting as paying agent in other cases when arrangements are put in place to make payments to UK customers of financial services firms.

4.96 The Government is considering including in FSMA a power to enable it to require the FSCS to act as described above in specific cases. The FSCS would not have to use its own funds (or raise levies) to make compensation payments under the new powers; the funds for this would have to be provided by the other scheme or persons responsible for paying compensation. The FSCS would also not be expected to bear any additional administrative costs that arose from this work.

Contributing to the costs of resolution

4.97 The Banking Act 2009 gave the Treasury a power to require the FSCS to contribute to the costs of the use of the SRR.

Following the enactment of the Banking Act 2009, regulations were put in place to allow the FSCS to be called upon to make a contribution towards the costs of the resolution of Dunfermline Building Society.[11] These regulations were not institution specific and therefore can apply to future resolutions. However, to fulfil the Government's commitment to consult on these

[10] *Banking crisis: dealing with the failure of the UK banks*, House of Commons Treasury Committee, April 2009, paragraph 88 (available from www.parliament.uk)
[11] The Financial Services and Markets Act 2000 (Contribution to Costs of Special Resolution Regime) Regulations 2009 (S.I. 2009/807).

regulations, the Government will shortly issue a consultation on the regulations for the FSCS to contribute to the costs of the SRR.

Pre-funding and protection of the taxpayer

4.98 The Banking Act 2009 included two new powers to strengthen the funding arrangements for the FSCS. These are:

- a power to allow the National Loans Fund to make loans to the FSCS to ensure that it has sufficient liquidity when needed; and
- a power to bring in pre-funding (a system in which contingency funds are built up in advance of need) for the FSCS if that is considered appropriate in future.

4.99 The Government made clear during the Parliamentary debates that it did not consider that it would be appropriate to introduce pre-funding at this time. This view was widely supported.

4.100 The Government is clear that the FSCS should be financed by the financial services industry. All parts of the industry benefit from the extra confidence that the existence of the scheme gives to their customers. But it is equally obvious that the industry would always have difficulty paying levies to fund very large compensation outlays or contributions to SRR costs in a short period. So it is essential to find methods of spreading such costs over time. The NLF borrowing facility enables the costs to be spread after a major failure has occurred. Pre-funding enables the costs to be spread before a major failure occurs.

4.101 The advantages of pre-funding are that it allows the costs to be spread over an even longer period of time than a post-failure borrowing facility would do on its own, that firms (especially the failed firm) pay for the benefits they receive from the existence of a compensation scheme at a time closer to the time when they enjoy those benefits and, as the House of Lords Select Committee on Economic Affairs recently observed, pre-funding would also have a counter-cyclical effect. The Select Committee recommended that the Government should move towards pre-funding as soon as practicable. The Government has noted the financial sector's concerns over affordability and that firms have to contribute capital, which may not be needed to pay compensation to consumers if no failure occurs and any introduction of pre-funding will need to take account of the wider context of the levies the banking sector is already having to pay to meet FSCS expenses arising from the 2008 defaults and the need for it to build up capital more generally.

4.102 The Government believes, therefore, that, subject to consultation, it would be appropriate to move towards the introduction of a pre-funded element in the FSCS covering the deposit-taking class.

4.103 The Government fully recognises the concerns that emerged in 2008 about the interest costs on the borrowings the FSCS had to incur in order for it to contribute to the costs of transferring accounts and paying compensation following the defaults that took place. Having taken account of the potential impact of these levies, the Authorities agreed that the total amount levied to meet interest and other FSCS management expenses would not exceed £1 billion a year in the following three years and the Treasury undertook that any interest costs above this amount would be waived rather than recharged at a later date. The Government has therefore decided that pre-funding will not be introduced before 2012. If pre-funding is introduced, the initial levy would not be set at a level which would compromise financial stability or undermine efforts to strengthen the banking system's ability to meet the demands of economic recovery and subsequent levies would build up over time consistent with increasing strength and capital resources of the banking system.

4.104 In line with the commitments the Government has given, there will be full consultation before the introduction of pre-funding including on the timing, coverage and levies for a pre-funded scheme. The Government will also take account of developments at the European level where the Commission is considering funding mechanisms and the case for the introduction of an EU-wide deposit-guarantee scheme. The FSA is also planning a review of the FSCS funding model and intends to consult in the financial year 2010-11.

Governance of the FSCS and FOS

4.105 The FSCS and the FOS were established by the FSA under FSMA. Both are companies limited by guarantee and with directors appointed by the FSA. The Treasury must approve the appointments of both chairmen. The FSA is required to ensure that both bodies are always capable of exercising their statutory functions but FSMA ensures that both bodies remain operationally independent from the FSA as well as the Government.

4.106 The existing arrangements for governance and accountability of the FSCS have worked well. Nevertheless, as announced in the 2009 Budget, the Government, working with the FSA and the FSCS, will bring forward proposals regarding the governance and accountability of the FSCS to ensure that it is best able to respond to the challenges that its new roles and responsibilities, and the changed environment for financial stability, will bring.[12] These proposals will not undermine or compromise the FSCS's independent position and role in the regulatory system.

4.107 The role of the Financial Ombudsman Service (FOS) is to settle individual complaints between consumers and businesses providing financial services, handling around a million enquiries and settling over 100,000 disputes annually. FSMA requires both the FOS and the Chief Ombudsman to make an annual report to the FSA on the discharge of their respective functions.

4.108 Although the recent challenges to financial stability have not impacted upon the role of the FOS in the same way as they have for the FSCS, the Government believes that it would be appropriate similarly to review the governance and accountability of the FOS to ensure that the arrangements remain fit for purpose under these new circumstances.

4.109 To that end, the Treasury, the FOS and the FSA will review these issues, reporting towards the end of the year. Any resulting proposals will not, however, undermine or compromise the FOS's independent position and role in the regulatory system. In the mean time, the FOS has decided that, subject to stakeholders' views, its next three-year review will cover its efficiency and effectiveness – similar to the 2007 review of the FSA that the Treasury commissioned from the National Audit Office[13].

Summary

4.110 This chapter has set out the Government's reforms designed to strengthen the objectives, powers and governance arrangements of the FSA and the Bank and make cooperation and coordination between these institutions and the Treasury more formal and transparent.

4.111 The overriding objective of these reforms is to put in place the correct institutional arrangements to help ensure that the regulatory authorities are able to deal effectively with the core regulatory issues set out in this paper; the challenge of how to deal with large systemic institutions, the question of how to detect and mitigate systemic risks and the need to use more

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[12] *Budget 2009: building Britain's future*, HM Treasury, April 2009, p.68 (available from www.hm-treasury.gov.uk)

[13] *The Financial Services Authority: a review under section 12 of the Financial Services and Markets Act 2000*, National Audit Office, April 2007 (available from www.nao.gov.uk)

counter-cyclical regulation to counter risks that build up over the cycle. These issues are considered in the following chapters.

5 Significantly systemic firms

The recent crisis has shown that problems in financial institutions of all sizes and functions can have knock on effects for the entire system. Predicting which firms are 'systemically significant' is not straightforward and any list of such firms would be dynamic and dependent on prevailing market conditions.

However, large, complex, financial institutions whose operations span many countries, and whose failure would represent a significant threat to financial stability, pose a particular challenge to authorities.

The Government's strategy for dealing with all systemically significant institutions will be to use:

- strengthened market discipline, especially through corporate governance and remuneration policies;
- enhanced prudential supervision by the FSA – both generally, and targeted specifically on large, complex firms;
- stronger resolution arrangements, both in terms of the regulatory toolkit, and the plans that large firms must make to manage their own failure; and
- improvements to the overall framework such as enhancements to market infrastructure in key markets to reduce the likelihood of contagion effects.

By reducing both the likelihood and the cost of failure, while tackling problems of moral hazard, this approach will allow the Government to address directly the main problems arising from systemically significant firms, including those that have been described as "too big to fail".[1]

Dealing with systemically significant firms

5.1 Financial institutions of all sizes and functions can have knock on effects for the entire system. Predicting which firms are 'systemically significant' is not straightforward and any list of such firms would be dynamic and dependent on prevailing market conditions. However, some market commentators[2] have argued that:

- larger, more complex firms are more likely to fail, due to the difficulties inherent in risk management and supervision, especially cross-border;

[1] Note that much of the discussion around systemically significant firms has classified such firms as "too big to fail", but this implies size is the only problem. In reality it is not just firm size, but also firm complexity that determines its systemic significance.

[2] Many analysts have contributed to the debate as to the treatment of systemically significant firms. It has been suggested that systemically significant institutions are aware of the implicit Government safety net, which can create moral hazard incentives for the institutions to partake in riskier activities. As a result this can lead to an increased likelihood of failure of systemically significant institutions: see, for example, *Too Big To Fail: The Hazards of Bank Bailouts*, Gary H. Stern, Ron J. Feldman, Brookings Institution Press, 2004 and *How Big a Problem is Too Big to Fail? A Review of Gary Stern and Ron Feldman's 'Too Big to Fail: The Hazards of Bank Bailouts*', Journal of Economic Literature, Frederic S. Mishkin, December 2006.

- when they do fail, the consequences are more severe; and
- these firms appear to benefit from explicit or implicit government guarantees of the retail business, by cross-subsidising non-guaranteed business, creating moral hazard.

5.2 The evidence does not uniformly support all of these assertions. Nevertheless, each of these issues needs to be tackled in addressing the question of systemically significant firms. The Government therefore believes that action in the following areas is necessary to tackle the risks posed by such high impact firms:

- to reduce the risk of systemically significant institutions failing:
  - stronger market discipline by market participants;
  - stronger prudential regulation of firms generally; and
  - enhanced prudential regulation specifically targeted at large and complex institutions, especially through linking capital requirements to the size of firms;
- to reduce the impact of the potential failure of systemic firms:
  - improvements to market infrastructure;
  - requiring firms themselves to have their own plans for resolution, to be implemented should they fail, supported by regulatory action where necessary; and
  - effective resolution mechanisms for the authorities to use in the event of failure.

5.3 Action in these areas, if effectively implemented, will also serve to mitigate the distortions caused by moral hazard, as all firms will have to manage themselves in a way that accurately reflects the risks they run, including the real possibility that they will be allowed to fail.

5.4 The Government is not, however, persuaded that artificial limits should be placed on firms to restrict their size or complexity. The arguments against such an approach are discussed in detail at the end of this chapter.

Reducing the risk of failure

Stronger market discipline

5.5 The Government believes that the primary responsibility for the efficient running of banks and other financial institutions must lie with the firms themselves. However, recent events have demonstrated that, in a number of important respects – including corporate governance, remuneration, and risk-management – many firms, both large and small, have failed to discharge this responsibility adequately.

5.6 There are two reasons why market discipline is particularly important in the context of systemically significant institutions. First, as their size and complexity make them intrinsically harder to manage, poor management may be more likely to lead to firm failure. Second, given that the impact and consequences of failure is larger for a systemically significant firm, there is a strong public policy need for such firms to demonstrate that they are being effectively managed and governed.

5.7 There are a number of respects in which the Government is further tackling the issue of market discipline. These include the Walker Review of corporate governance, the remit of which has been extended from banks to other financial institutions where relevant. A consultation document on the Review's initial recommendations will be published shortly, with final

conclusions in the autumn. The FSA has published a Code of Practice on remuneration, which it intends to add to the FSA handbook. This consultation on the Code has recently closed, and the FSA is currently reviewing responses with a view to having the Code in place for firms' 2009 remuneration processes. The FSA will present to the first meeting of the new Council for Financial Stability (CFS) on its new Code, and remuneration practices by firms, and will provide an annual report on remuneration practices and the risks they pose to financial stability.

5.8 The Government is, through the work of the Walker Review and the FSA's Code of Practice, providing guidance on standards of discipline in corporate governance and remuneration, and generating a framework for action on the issue by market participants. There is also a role for the FSA in establishing and maintaining dialogue on governance issues with non-executive members of boards. But ensuring strong market discipline ultimately remains the responsibility of market participants – boards, other senior management and shareholders – themselves.

Prudential regulation

5.9 The Government, together with the FSA, is already implementing a number of policy changes within the UK that, although targeted at all regulated firms, will particularly help in managing the risk potential of systemically significant or "high impact" firms. More stringent prudential regulation and supervision will help ensure that large or complex firms hold appropriate levels of capital and effectively manage liquidity risks.

5.10 More action is needed, however, to ensure that the particular problems posed by systemically significant or "high impact" firms are better managed.

Linking capital requirements to the size and complexity of a firm

5.11 The Government believes that systemically significant firms should, consistent with risk-based regulatory approaches, be subject to more regulation. This would include higher capital requirements, thus "internalising" their higher costs of failure. This would go beyond current practice, with the FSA in future determining level of capital by reference to the potential cost as well as the likelihood of failure.

5.12 The capital requirements in place for systemically significant institutions would need to be sufficient to change incentives of banks to over-indulge in risky activities throughout the economic cycle. This should encourage them to reduce or at least better understand the riskier activities they undertake (for example, proprietary trading) and reduce the moral hazard problem by removing the incentive for firm to become systemically significant.

5.13 Such a change would benefit from international co-ordination in order to avoid the risk of regulatory arbitrage between countries and this approach is currently being considered elsewhere. For example Switzerland has said it plans to introduce a variant of this approach, by requiring that in good times banks build up capital up to a target level of 200% of current requirements, corresponding to a fraction of 16% of risk-weighted assets -- a target to be reached by 2013 at the earliest. The country's systemically important banks will be expected to hold mainly Tier 1 capital.

5.14 The US also propose to link regulation of systemically important firms to capital requirements. The US Treasury's recent proposals recommend that, "the prudential standards for Tier 1 Financial Holding Companies (FHCs)[3] – including capital, liquidity and risk management standards – should be stricter and more conservative than those applicable to other financial

[3] 'Tier 1 Financial Holding Companies' is the term used in the US to refer to systemically significant firms

firms to account for the greater risks that their potential failure would impose on the financial system".[4]

5.15 In summary, these measures taken together, including stronger market discipline; improved prudential regulation; and stronger capital requirements for systemically significant firms, will reduce the likelihood of failure of high-impact firms. Reducing the costs in the event of failure is equally important, as discussed below.

Reducing the impact of failure

5.16 The measures above do not go far enough in tackling the additional costs of failure of systemic institutions. To ensure that firms do face a credible threat of failure, further measures are needed to limit the systemic impact that an actual failure would have.

Market infrastructure

5.17 Chapter 6, on managing systemic risk across financial markets, discusses improvements in market infrastructure that are needed to ensure that there are sufficient "firebreaks" in place within the financial system to limit systemic contagion. Strengthening market infrastructure is already in progress and the authorities have been working with European and US regulators. This will enhance legal and operational infrastructures of CDS markets to strengthen their ability to continue to function in the event of a major market participant failing.

5.18 By enabling the system better to contain the potentially systemic consequences of a significant institution failing, the impact of firm failure will be reduced.

Resolution

5.19 Effective resolution mechanisms are an important element in maintaining failure as a credible option for large and complex firms. The Banking Act 2009 created a range of resolution tools to ensure the effective resolution of deposit takers. Furthermore, when it became clear from the events of 2008 that risks faced by deposit-takers could spread to the wider group in which the deposit-taking business sits, the Act was amended during its passage to provide for the resolution of holding companies of deposit-takers. The US has recently announced its intention to follow the UK in taking this latter step through its regulatory reform plan. In May, the Government issued a consultation on developing effective resolution mechanisms for investment banks, following the emerging lessons of the global failure of Lehman Brothers, which closes this week.[5]

5.20 However, to supplement this, the Government also believes that firms themselves must plan for effective resolution and organise themselves internally so that this can be executed easily. In January 2008, the consultation document "Financial stability and depositor protection: strengthening the framework" set out the Government's view that "banks need to be adequately prepared to minimise the disruption arising from their own failure"[6]. The Government recognises that action by banks in this area will require greater regulatory focus on the matter.

5.21 As a result, the Government will work with the FSA and the Bank of England to ensure that all banks are adequately prepared and organised internally for their own resolution. These resolution plans should be proportionate to the size and complexity of the bank in question, and should include an assessment of how difficult it will be to resolve. The Government believes that

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[4] See *Financial regulatory reform: a new foundation*, US Treasury, June 2009, p.24 (available from www.financialstability.gov)

[5] *Developing effective resolution arrangements for investment banks*, HM Treasury, May 2009

[6] *Financial stability and depositor protection – strengthening the framwork*, HM Treasury, January 2008

the quality of a bank's resolution plan should have a direct bearing on the FSA's overall assessment of the prudential risks borne by the firm, including, if necessary, by feeding into regulatory capital and / or liquidity requirements.

5.22 The nature of these improved resolution arrangements will be subject to consultation (see the annex of this document for more details). It will be important that firms establish clear contingency plans for action in times of failure. This may necessitate plans for revisions to corporate structures of some institutions, which may include establishing clear lines between deposit-taking and other banking operations, so that the depositor book can be easily sold to a competitor in times of failure with minimum disturbance to the confidence of depositors. The FSA will discuss the corporate structure of financial institutions in the context of these contingency plans, in order that in the event of failure the plans can be implemented at short notice.

Framework for implementation

5.23 The Government will work with the FSA and the Bank of England, as well as international partners, to develop a framework for identification and stronger regulation of systemically significant institutions and produce findings by the end of this year, with conclusions on the appropriate institutional arrangements for implementing this framework to follow.

5.24 Judging whether a firm is systemic is not straightforward. Importantly, systemic risk is state dependent and dynamic. Individual institutions may not be considered systemic in normal circumstances, but may become systemically significant in specific situations, as was the case with Northern Rock. Further, in certain circumstances, failure of a firm, if managed well, could have relatively limited systemic consequence. This was the case with Dunfermline Building Society and Bradford & Bingley. However, there are also firms whose failure would probably be systemic in most circumstances and which would always be expected to pose significant challenges to resolve.

5.25 Systemically significant institutions are typically, but not necessarily, regulated firms such as banks. Other financial market participants outside the regulatory perimeter could, in some circumstances, be individually systemically significant. Unregulated off-balance sheet vehicles have contributed to heightened systemic risks in a collective way, but examples of these and other financial institutions may become systemically significant in future. And as highlighted in the next chapter, this means that the regulatory system must adapt by providing for flexibility in the regulatory perimeter.

5.26 In April 2009, the G20 asked the Financial Stability Board (FSB) to work on producing guidelines for national authorities to assess whether a financial institution, market, or instrument is systemically significant. Additionally, a recent Geneva Report on the World Economy provides a simple yet potentially useful classification of the potential systemic risk posed by a financial institution.[7]

5.27 The Government will work with the FSA and the Bank of England, as well as international partners, to develop a framework for identification and stronger regulation of systemically significant institutions and produce findings by the end of this year, with conclusions on the appropriate institutional arrangements for implementing this framework to follow.

5.28 The implementation of this framework in practical terms will be subject to consultation (see the technical annex to this document), specifically with regard to the challenges of identifying

[7] In descending order of systemic impact, the report classifies firms as: individually systemic; systemic as part of a herd; non-systemic large; and "tinies", (their lowest level of firm which may be systemically important). For further information, see: "The Fundamental Principles of Financial Regulation" Brunnermeier et al. *Geneva Reports on the World Economy*, 2009.

and categorising systemically significant firms. As discussed above, there are some firms that are likely to be systemically significant in most circumstances, but many others whose importance will be context specific. Firms can also manage their own level of systemic importance, by improving market discipline and ensuring effective resolution plans are maintained.

Imposing limits on size or complexity

5.29 Commentators proposing limits on financial institutions' complexity – the so-called "narrow" versus "broad-bank" debate – often cite the "Glass-Steagall" Act in the US. Others refer to the need to limit the size of banks so that they do not become so large as to benefit from implicit state guarantees.

Box 5.A: Glass-Steagall Act 1933

The Glass-Steagall Act (the US Banking Act 1933) was introduced after the 1929 US stock market crash. Some argued that "improper banking activity" and the over-involvement of commercial banks in investments on stock exchanges had significantly contributed to the crash. The provisions set out in the Act resulted in:

- the creation of the Federal Deposit Insurance Corporation (FDIC);
- the prohibition of commercial banks from engaging in investment banking- intended as a means of protecting bank depositors from the additional risks associated with security transactions.

The Act was aimed at restoring confidence in the US banking sector by forcing a clear and distinct separation of commercial and investment banking activity, thereby preventing commercial banks from underwriting securities. Similarly, investment banks were prohibited from engaging in deposit-taking activities.

However, the limitations of the Act later became subject to debate. The Act's explicit separation of commercial banking from securities issuance was believed to be anti-competitive, preventing firms from generating enough market-making activity that would enable them to deliver a full range of risk-management products. More recently, increased transparency and disclosure requirements were thought to enable better discipline, thus removing the need for actual restrictions on business form.

As a result, in 1999, the Glass-Steagall Act was repealed, via the Gramm-Leach Bliley Act.

The UK has never introduced legislation similar to Glass-Steagall. However, it did have some restrictions on combined banking activities prior to the "Big Bang" in 1986, after which the UK securities industry was transformed by permitting competitive pricing for brokerage and allowing banks to invest in stock exchange member firms.

5.30 Proponents of formal limits on the size or activities of banks focus on the need to protect the core banking system from risks to depositors, the taxpayer and wider financial stability arising from risky investment activities. They also believe that, as firms grow to a certain size, they become beneficiaries of implicit or explicit guarantees by governments, which they use to justify or subsidise certain forms of speculative activity. The approach assumes that smaller, less complicated institutions should be easier and less costly to wind down.

5.31 There are strong counter-arguments to all these points. First and most significantly, there is little evidence to suggest that artificial restrictions on a financial institutions' size or complexity, including introducing a distinction between commercial and investment banking activity, would automatically reduce the likelihood of firm failure:

- a fundamental assumption of the Glass-Steagall approach is that there is in fact an absolute size below which a firm can be safely left to fail. Events of the last 18 months have demonstrated that this is clearly not the case. Banks of all sizes – not just institutions above a certain size – have encountered difficulties, challenging the assertion that only larger banks are likely to fail or have systemic consequences. Caps on size, therefore, may not be an effective way of managing risk;
- moreover, some institutions that failed engaged solely in commercial lending or investment banking activity, while one of the most significant failures of all – AIG in the US – was not even a bank. The existence of Glass-Steagall provisions would have failed to address these two points;
- crucially, the Glass-Steagall approach does not guard against systemic risk contagion between firms, which as recent events show can easily travel between pure deposit-taking institutions (large or small) and large investment banking institutions;
- while many large, universal, banks lost money on trading activities, they also suffered losses as a result of bad lending, poor corporate governance and risk-management procedures. The latter are examples of basic problems that can exist across both "narrow" and "broad" banks, again transcending the Glass-Steagall divide.

5.32 Second, the aggregate economic costs in the event of failure would not necessarily be reduced. Separating commercial banks from investment banks would not address counterparty risk exposures between banks, nor tackle liquidity problems arising from the cessation of inter-bank lending in the event of a single firm failing. Lehman Brothers was an investment bank, but its failure led to wide and varied knock-on effects to the rest of the financial system.

5.33 Third, there are benefits to the economy in having access to the services of large, broad institutions, which can use scale and scope to provide for risk diversification, as long as there are sufficient regulation and other safeguards as discussed earlier. Additionally, some large or complex banks are by nature likely to be international in business coverage, facilitating more cross-border investment and trade, and broader and larger banks provide a vital form of intermediation between the capital markets and the real economy; as a result some efficiency of allocation would be lost.

5.34 Fourth, there are practical challenges to implementing this approach. It would be extremely difficult to identify any optimum threshold for the size or scope of financial institutions, let alone to mitigate the moral hazard problems that come with specifying this threshold to the market.

5.35 Finally, a Glass-Steagall-style separation would need to be applied across all countries to be effective. In the absence of any global consensus on this approach, and on what the appropriate threshold for bank size or breadth might be, the introduction of these restrictions could inhibit the growth and continued competitiveness of the UK financial market, and might encourage even sound UK financial institutions to move to other countries.

5.36 For the reasons set out above, the Government does not believe that Glass-Steagall style provisions, with artificial limits to firm size or breadth, would constitute a suitable response to the question of how to effectively manage the risks of systemically significant institutions.

5.37 Instead, the Government's believes that the best strategy for dealing with systemically significant institutions will be through measures to;

- strengthen market discipline, especially corporate governance and remuneration;

- enhance prudential supervision – both generally and specific to large, complex firms. This will include requiring systemically important institutions to hold higher levels of capital;
- maintain stronger resolution arrangements, including requiring large firms to make plans to manage their own failure; and
- improve the macro-prudential framework such as enhancements to market infrastructure in key markets to reduce the likelihood of contagion effects.

5.38 By reducing both the likelihood and cost of failure, while also tackling problems of moral hazard, this approach will enable the Government to directly address the problems that might arise from the existence of high impact firms that might be deemed "too big to fail".

Summary

5.39 This chapter has described the approach the Government proposes to tackle the problems of systemically significant firms. The measures proposed will reduce the likelihood and the cost of failure of high impact firms; they also tackle the problem of moral hazard in large firms.

5.40 The measures the Government proposes include requiring that systemically significant firms be subject to more regulation. This would include higher capital requirements, thus forcing the firms to "internalise" their higher costs of failure. The Government will work with its partners to develop a framework for identification and stronger regulation of systemically significant institutions. Findings will be published by the end of this year, with conclusions on the appropriate institutional arrangements for implementing this framework to follow. The Government will also work with the FSA to ensure that all banks are adequately prepared for their own resolution.

5.41 The next chapter turns to measures taken to tackle systemic risk more broadly.

6 Managing systemic risk

Regulators and central banks need to work together to look at the financial system as a whole. The Government believes that measures are needed to manage systemic risk across markets through:

- enhancing transparency over financial institutions' risk exposures, with a view to facilitating better risk management and strengthening market discipline;
- improving the functioning of systemically important wholesale financial markets, in particular securitisation and derivatives markets; and
- an enhanced focus by the FSA on monitoring, assessing, and where appropriate, taking action to mitigate systemic risks arising from interlinkages across the financial system.

The Government also believes that action is needed to achieve the following objectives:

- dampen excessive credit conditions and risk-taking in the financial system which can amplify an economic upturn; and
- ensure that banks are more resilient to economic shocks when they occur to prevent them amplifying an economic downturn.

This can be achieved primarily through rules-based measures, but regulators and central banks need to go further to also consider discretionary approaches to managing systemic risk over the cycle. Clearly, any new tools would need to be developed at an international level and the UK will work closely with its international counterparts to achieve this.

6.1 Regulators and central banks need to devote proper attention to the health of individual institutions. But they also need to work together to look at the system as a whole. They need to understand:

- how the complex inter-linkages across financial markets, and financial institutions' tendency to respond in common ways, can threaten stability;
- the cyclical nature of risk-taking in financial markets, which can cause the extent and nature of threats to financial stability to fluctuate over time; and
- the links between the financial system and the wider economy.

6.2 This chapter sets out the steps that the Government, the Bank of England and the FSA need to take to implement such an approach, recognising that to be effective, any changes need to be adopted and coordinated internationally.

Managing systemic risk across markets

6.3 As discussed in Chapter 3, the crisis has demonstrated how the response of market participants can transmit and amplify shocks through markets to impact on otherwise

unaffected institutions. Regulation and supervision need to focus on monitoring and mitigating systemic risk arising from the interlinkages across the financial system.

6.4 There are a number of tools to improve management of risk across institutions and markets, including:

- enhancing transparency by improving accounting standards;
- improving the liquidity, transparency and robustness of wholesale markets, and in particular securitisation and over the counter (OTC) derivatives markets through: increasing standardisation of products; strengthened wholesale market infrastructures; and increasing the amount of due diligence undertaken by investors; and
- greater regulatory focus on systemic risk including through enhanced monitoring and supervision and creating a responsive and dynamic regulatory boundary.

Enhancing transparency

6.5 The recent financial crisis has shown that inadequate public disclosures about financial institutions' risk exposures can contribute to the freezing of key financial markets, and in particular funding markets, in times of stress. Greater transparency enhances market discipline, facilitates better risk-management and contributes to the maintenance of market liquidity in distressed conditions

6.6 A number of steps have already been taken in the UK and internationally, resulting in significant improvements in risk disclosures by banks. At the London Summit, the G20 called on accounting standard setters to further enhance transparency to markets of financial institutions' risk exposures and improve the quality and consistency of valuations of financial instruments. Specifically, the G20 endorsed the FSF recommendation that accounting standard setters should, by the end of 2009:

- reduce the complexity of accounting standards for financial instruments;
- strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information;
- improve accounting standards for provisioning, off-balance sheet exposures and valuation uncertainty;
- achieve clarity and consistency in the application of valuation standards internationally, working with supervisors;
- make significant progress towards a single set of high quality global accounting standards; and
- within the framework of the independent accounting standard setting process, improve involvement of stakeholders, including prudential regulators and emerging markets, through the International Accounting Standard Board's (IASB) constitutional review.

6.7 The Government strongly supports these recommendations and agrees that the FSA should engage with firms and auditors to ensure more consistent approaches in the valuation of financial instruments across firms. The Government will seek to secure agreement from its international partners that their supervisors will do the same.

Wholesale market functioning

6.8 Wholesale markets have traditionally been (at most) lightly regulated. This was based on the rationale that they are made up of sophisticated market participants and so do not raise consumer protection issues. However, the global financial crisis has demonstrated that these markets can transmit shocks to otherwise unaffected firms and the economy. Therefore there is a need to look more systematically at the structure of key wholesale markets in which financial institutions operate and take a considered approach to the systemic risks that they pose, especially liquidity.

Securitisation markets

6.9 As explained in Chapter 2, particular securitisation practices played an important role in increasing uncertainty about the amount of risk held on financial institutions' balance sheets. Rather than repackaging securities and selling them to investors better suited to manage the risks, they often remained with banks or with conduits or other institutions connected to banks. This concentrated risks among a relatively small number of institutions in the banking and shadow-banking sectors. As the prices of securitised assets fell banks were all looking to reduce their exposures together, with the result that the markets became illiquid.

6.10 The key to avoiding such periods of illiquidity is to have many more market participants as buyers and sellers, other than banks and their conduits. To attract such investors, greater product standardisation and transparency are necessary to ensure that a broad class of investors can fairly judge the value and risk profile of securitised assets in all market conditions, not just when prices are rising. This requires some certainty over the quality of the underlying assets.

6.11 The Government is taking further action to increase transparency and encourage greater standardisation in securitisation markets through:

- supporting the work of the European Securitisation Forum (ESF). The ESF published new residential mortgage-backed securities (RMBS) principles in February 2009, based on consultation with market participants, in order to establish standards of consistency, transparency and accessibility for investors in European RMBS.[1] The Government welcomes this initiative as a step towards establishing more robust markets in the longer term; and

- requiring all participants in the asset-backed securities guarantee scheme (referred to in Chapter 1) to comply fully with international best practice on disclosure and ongoing reporting. The Government has encouraged the industry to produce standardised templates by the end of 2009, as announced in Budget 2009.

6.12 In addition, the Government has introduced legislation to encourage the development of the UK covered bond market.[2]

6.13 These steps to increase standardisation and transparency in securitisation markets are being reinforced by actions at EU level, to ensure that the ability to transfer credit risk through securitisation markets does not reduce incentives for those originating and securitising loans to assess and monitor ongoing credit quality. In particular, changes to the EU's Capital Requirements Directive (CRD) will restrict the purchase by EU-regulated banks of securitisations

[1] *Press release: ESF releases RMBS Issuer Principles for Transparency and Disclosure*, European Securitisation Forum, February 2009 (available from www.europeansecuritisation.com)

[2] The UK Covered Bond Regulations entered into force on 6 March 2008 and will enable UK covered bonds to meet the requirements of the Undertakings for Collective Investment in Transferable Securities (UCITS) directive. The legislative framework should help encourage investor confidence in UK regulated covered bonds, as the regulations set out eligibility criteria for the assets that may be included in the cover pool.

where the originator or distributor does not itself retain a net economic interest of at least 5 per cent. The UK supports this measure.

Derivatives markets

6.14 Over the counter (OTC) derivatives markets, and in particular the credit default swaps (CDS) market, have greatly increased the size of counterparty claims between firms in the financial system. Moreover, because OTC contracts are on a bilateral basis rather than through central counterparties (CCPs) or exchanges, there is little transparency about the nature and location of risks arising in these markets, making assessments of counterparty risk more difficult.

6.15 Particular concerns exist around the limited availability and use of CCPs in derivatives markets. The benefits of CCPs are discussed in more detail in Box 6.A.

Box 6.A: Central counterparties (CCPs)

CCPs are widely used in financial markets to reduce counterparty risk. The CCP acts to guarantee the performance of the contracts that it clears. It fulfils this role by becoming the buyer to every seller and the seller to every buyer for every contract it clears. Accordingly, if one party to the trade defaults, the other is unaffected and will still be able to settle the trade. This provides private benefits to the participants in a trade by managing their counterparty risk in an efficient and cost-effective manner, and may help to enhance market liquidity. Robust CCPs also bring public benefits by reducing the scale and complexity of counterparty exposures and acting as firebreaks to contain the potentially systemic consequences of the failure of a major market participant. Finally, CCPs can provide a central registry to allow regulators access to the information they need to assess the implications of the failure of a major market participant.

CCPs concentrate risk, so it is vital that they are closely supervised with high prudential and operational standards. Central counterparties hold substantial and highly liquid capital reserves (including margin monies and a socialised "default fund") so they can absorb the cost of a member defaulting. Members of a CCP post collateral or margin for each trade that varies according to the CCPs rules. The level of margin required will be set by the CCP and will depend largely on the potential price volatility of the product being cleared.

CCPs exist for both exchange traded and over the counter or OTC (i.e. off-exchange) markets. Only standardised trades can be cleared on a CCP – managing the risk of high volumes of non-standardised trades would be impractical. The legal status of CCPs is not covered by EU law and therefore the UK has its own recognition regime.

6.16 The Government is taking the following action to enhance the robustness and functioning of key derivatives markets:

- the Chancellor recently called for an EU Clearing and Settlement Directive to bring CCPs within a harmonised EU legislative framework, including CCPs for derivatives. Recent work by the European System of Central Banks (ESCB) and the Committee of European Securities Regulators (CESR) to develop recommendations on standards for CCPs provides a strong basis for any directive, which must achieve high prudential and operational standards;

- the Government believes that derivatives that are standardised, liquid and have price transparency should be cleared on a CCP and is working with industry to determine in a fair and objective manner which product types could become suitable for clearing on a CCP, and to produce a roadmap delivering the necessary improvements;

- for the proportion of the derivatives market that will not be suitable for clearing on a CCP because the products are bespoke, illiquid or new, the Government is supporting international efforts to ensure that counterparty risk be mitigated through bilateral collateralisation and risk-appropriate capital charges;[3] and
- the Government supports the principle of greater transparency of counterparty risk to both markets and regulators, where this does not reduce liquidity or market functioning. Derivatives trades not cleared on a CCP should be reported to a trade repository to provide a prime record of the trade. Information in trade repositories and CCPs must be made available to regulators, and the Government supports recent work by the US and European authorities to ensure this takes place. Trade repositories and CCPs should publish aggregated information on positions and trades that do not identify individual firms as soon as possible.

Due diligence

6.17 Investors in structured products (including but not limited to banks) frequently failed to carry out sufficient due diligence and relied too much on credit rating agency assessments. Greater standardisation should facilitate investors in carrying out more effective due diligence of credit risk through the cycle.

6.18 The CRD also includes tough qualitative requirements on investor due diligence and originator transparency, building on industry-led work. These requirements will, from 2011, ensure that investor credit institutions must demonstrate that they have understood and implemented formal policies and procedures for analysing and recording, among other things:

- the level of retention by originators;
- the risk characteristics of the securitisation position, and the underlying exposures; and
- all structural features of the securitisation that may materially impact the credit institution's securitisation position.

6.19 Investors will also be required to establish formal policies and procedures for ongoing monitoring of performance of the exposures underlying their securitisation. Originators will be required to apply the same standards to securitised exposures as to exposures they would apply to exposures held on their own book.

Regulatory focus on systemic risk

6.20 While steps to enhance transparency will help to improve risk-management by firms, there is also a need for enhanced focus on monitoring, assessing and, where appropriate, taking action to mitigate systemic risks arising from inter-linkages between firms.

Monitoring

6.21 Enhanced focus on systemic risk across financial markets requires greater information gathering and monitoring. Under FSMA, the FSA has extensive powers to request and collect information from financial institutions. The Banking Act 2009 extended these information-gathering powers to allow the FSA to collect information that is relevant to the stability of individual firms and the financial system as a whole.

[3] In particular the Government is working with the Basel Committee's review of counterparty risk exposure for CCPs and the work of the Operations Management Group, which represents a number of major OTC derivatives dealers, and the International Swaps and Derivatives Association, a global financial trade association, to strengthen specific areas of bilateral collateralisation, in particular improving dispute resolution.

6.22 The FSA will need to increase its focus on understanding the nature of the inter-relationships and networks between firms and proactively identifying systemic vulnerabilities. This includes having detailed knowledge of types of banks assets and liabilities, to enable the FSA to assess how they may individually and collectively respond to shocks. In addition, a focus on systemic risk across the financial sector requires enhanced oversight of risks arising in key financial markets, which in turn requires greater transparency to supervisors about institutions' exposures in those markets. The FSA will need to increase its focus on monitoring and assessing how these key markets might trigger or amplify a shock. In particular, the FSA should concentrate on markets which could have a systemic impact, and ultimately an impact on the economy as a whole if they froze or failed to function under stress (as happened to the residential mortgage-backed securities market) and where large counterparty exposures exist between market participants (e.g. CDS markets).

6.23 As discussed in Chapter 4, the Government will consider whether additional information gathering powers are required to enable the FSA and the Bank of England to carry out their responsibilities for financial stability.

Supervision and regulation

6.24 As discussed in Chapter 4, the FSA implemented a supervisory enhancement programme (SEP), initially in response to lessons learned from evaluating its supervision of Northern Rock, which has since been expanded to cover more systemic or macro-prudential analysis by the FSA and closer involvement of the regulator in banks' published accounts and audits. The Government supports the improvements set out by the FSA under its SEP and the expansion in regulatory analysis. The FSA's recently announced new integrated operational structure will also serve to better align the FSA's internal operating model to its core activities of identifying and mitigating risk, supervision and enforcement.

6.25 Enhanced firm-by-firm regulation, together with strengthened internationally agreed prudential regulatory standards, will play an important role in making the global financial system as a whole more resilient to shocks. This includes:

- increasing the quality and quantity of capital that firms are required to hold to ensure that there is sufficient high quality capital in the financial system as a whole to absorb a major shock;
- enhanced regulation of liquidity risk to ensure that financial institutions are better able to survive market wide liquidity shocks;
- more robust stress-testing focused on assessing the resilience of financial institutions in the context of systemic stress, including common scenarios prescribed by regulators; and
- tougher prudential regulation for systemically significant institutions, as discussed in Chapter 5.

6.26 Further, as discussed in Chapter 4, the Government will ensure that the FSA's objectives and powers are designed in a way that strengthens the FSA's system-wide focus alongside its firm-by-firm supervision of individual institutions. It will do this through, subject to consultation:

- reviewing and amending the FSA's objectives and the principles of good regulation to clarify that:
  - the FSA's regulatory and supervisory approach should include an enhanced focus on monitoring, assessing and mitigating systemic risks; and

- o the FSA's regulatory decisions should take into account the wider economic costs of financial instability in addition to the immediate impact on market confidence and the direct costs to consumers of financial services.

- enhancing and extending the FSA's enforcement powers to ensure that it has the ability to:
  - o take action to address systemic risk and protect financial stability;
  - o sanction firms or individuals that are guilty of misconduct; and
  - o take emergency action to place restrictions on, and to require disclosure of, short-selling.

A responsive and dynamic regulatory boundary

6.27 Effective regulation of systemic risk also requires the FSA to reconsider its role in market sectors that have not historically fallen within the boundary of prudential regulation. System-wide volatility over the past two years has been driven not just by the activities of directly regulated firms but also by other financial market actors.

6.28 The Government believes, therefore, that the setting of the regulatory perimeter should be determined according to the principle that financial activities should be regulated according to their economic substance and the risks they pose, not their legal form.[4]

Off-balance sheet vehicles

6.29 The Government is fully committed to the principle that firms and supervisors should have comprehensive oversight of a firm's exposures to 'related entities', such as structured investment vehicles and other off-balance sheet financing vehicles, and that this should be reflected in the regulated firm's capital and liquidity requirements. This is an international concern that requires changes to the way that related entities are treated. Important steps are being taken internationally to change both prudential and accounting frameworks to achieve these objectives:

- in January 2009, the Basel Committee on Banking Supervision (BCBS) issued consultation proposals to strengthen the risk capture of the Basel II framework. These include enhancements to the capital treatment of securitisations, off-balance sheet exposures, and trading book activities; and

- The International Accounting Standards Board (IASB) is taking steps to strengthen the accounting treatment of off-balance sheet exposures and, to this end, has issued for public comment proposed accounting changes for consolidation of off-balance sheet entities.

Hedge funds

6.30 Hedge funds are a relatively small part of the financial system in terms of the assets they manage – thought to be around $1.2 trillion. However, they can behave in ways that make them more important to the financial system than size alone suggests. For example, if they are forced to sell assets, they can rapidly become demanders of liquidity, potentially leading to serious market disturbances.[5] Further, they can also contribute to systemic risk through their

[4] *A regulatory response to the global banking crisis*, Financial Services Authority, March 2009, p.7 (available from www.fsa.gov.uk)

[5] *The trillion dollar meltdown: easy money, high rollers, and the great credit crash*, C Morris, 2008, p.113

interactions with bank counterparties, as happened in the near-collapse of Long-Term Capital Management in 1998.

6.31 The hedge fund industry is already regulated, and the UK regulatory regime is among the most advanced in the world. However, given the important role hedge funds can play in the financial system, it has become clear that public authorities need more information about their activities to ensure their impact is fully understood and any systemic risks properly mitigated. To this end:

- the Government supports the Turner Review recommendation that hedge fund managers located in the UK should be subject to enhanced disclosure requirements and is working with the FSA to put in place a system of enhanced surveillance that can gather relevant and timely information on the funding, leverage, investment strategies and, in some cases, investment positions of individual funds managed from the UK;
- the FSA and the Government will also act to ensure that this new oversight regime is backed by a credible enforcement framework. This could include requiring further information or requiring funds to reduce leverage or unwind investment exposure to overheated market sectors. Such action is only likely to be necessary in exceptional circumstances;
- the Government is committed to working closely with international partners to develop effective mechanisms for information sharing on a confidential basis with other national supervisors. This follows on from the G20's commitment to cooperating globally to achieve appropriate oversight and supervision of hedge funds or their managers; and
- at the EU level, the European Commission published a proposal for a directive on Alternative Investment Fund Managers on 29 April 2009. The Government welcomes the Commission's attention to this important issue and supports the principle of a coordinated EU approach to hedge fund regulation as part of a broader international effort. However, we believe that the proposal, which was produced in a very short time and with no public consultation, requires significant improvement. The Government will engage positively in the EU debate with the aim of developing a directive that achieves the necessary improvements in the EU regulatory framework, without imposing unnecessary burdens.

Keeping the regulatory perimeter under review

6.32 Financial innovation is an important part of the financial system. It provides new and better products that have real benefits for customers and keeps UK financial services competitive, supporting the UK as a major financial centre.

6.33 In many cases financial innovation is benign and can be regulated or supervised by the authorities within the current framework. However, financial innovation can create new risks. In these latter cases it is vital that the authorities identify these risks as they emerge and, if necessary, put in place an appropriate framework of oversight and regulation.

6.34 To this end, the Treasury will ask the FSA to update it about relevant aspects of financial innovation, including areas where the FSA's scope of authority or existing powers are not sufficient for it to fulfil its statutory objectives. In response, the Government will give full consideration to any legislative changes that may be necessary.

Effective and transparent coordination

6.35 These new approaches and powers will strengthen the ability of the authorities, each within their own area of responsibility, to take the actions necessary to safeguard stability and mitigate systemic risk. The success of the overall effort will, however, depend on strong and transparent coordination between the FSA, the Bank of England and the Treasury.

6.36 As set out in Chapter 4, the Government intends to legislate to create the Council for Financial Stability (CFS), which will strengthen and formalise the coordination and cooperation between the authorities in safeguarding the stability of the UK's financial system.

Managing systemic risk over the cycle

6.37 As explained in Chapter 3, financial markets have proved prone to periods of overly accommodative lending conditions in good times, and overly restrictive conditions in downturns. This can amplify the economic cycle, making the expansion phase greater and the following downturn more severe. This co-movement between lending conditions and the cycle is often described as pro-cyclicality.

6.38 There is an international consensus that changes to regulation are needed to achieve the following objectives:

- to dampen excessive credit conditions and risk-taking in the financial system which can amplify an economic upturn; and
- to ensure that banks are more resilient to economic shocks when they occur to prevent amplifying an economic downturn.

6.39 The design of policy instruments to achieve these objectives is still being debated internationally, but the Government believes that important powers include:

- regulatory rules-based powers including: leverage ratios; reducing the procyclicality of regulatory and accounting standards; requirements to encourage the build up of buffers of capital in times of economic expansion; and mechanisms to improve banks' access to capital markets in the event of an economic or financial downturn; and
- discretionary powers: including more effective official communication and varying regulatory settings in response to the build up of risks in the financial system.

6.40 The Government is working closely with the FSA and the Bank and in international fora to develop these tools. Given the global nature of financial markets, and the ease with which banks and financial institutions can transfer internal resources, one country acting alone is unlikely to be effective. It is essential, therefore, that governments work together to coordinate the development of the types of policy tools to mitigate risks from pro-cyclical behaviour in global financial markets. The work of the FSB and new European Systemic Risk Board (ESRB) will be key in facilitating this coordination. The challenge is to take into account the different economic cycles in countries in which these policy tools will be applied.

Regulatory rules-based tools

Leverage ratio

6.41 Leverage refers to the extent to which a financial institution (or any other business) is funded using borrowed money as opposed to its own capital. In the run up to the crisis the degree of leverage of major UK banks increased significantly. The fact that these banks were

meeting their Basel II requirements, which specify how much capital banks need to hold against risk-weighted assets, did not prevent this build-up of leverage.

6.42 The Government therefore believes that risk-weighted capital requirements need to be supplemented with a leverage ratio. During good times, when risk can be systemically underestimated by the risk-based models and those who use them, a leverage ratio (total assets to capital) seeks to provide a "backstop" to ensure minimum capital levels are maintained. On its own a leverage ratio can create undesirable incentives in that it may encourage banks to invest in riskier assets. However, this would affect the Basel II risk-weighted capital ratio by raising the amount of capital required by the banks. This is why it is important that a leverage ratio is a complement, rather than an alternative, to risk-weighted capital requirements.

6.43 G20 countries committed in April in London to the introduction of a form of leverage ratio. To this end, the Basel Committee is taking forward work to use leverage ratios as a supplement to risk-based capital requirements. The Government believes that any leverage ratio should be internationally comparable and inclusive of off-balance sheet items to reduce the risk of jurisdictional and regulatory arbitrage.

Reducing the pro-cyclicality of prudential and accounting standards

6.44 As explained in Chapter 3, there are concerns that risk-based capital requirements and mark-to-market accounting may increase the inherent pro-cyclicality of financial markets. The Government supports ongoing work at the international level, led by the Basel Committee and the IASB, to ensure that international regulatory and accounting standards do not act to amplify the inherent pro-cyclicality of the financial system. Steps include:

- reviewing the risk measurement methodologies used as the basis for calculating regulatory capital requirements, including encouraging the use of through-the-cycle measures of risk and reviewing the reliance on credit ratings under Basel II; and
- changes to accounting rules to dampen the potentially pro-cyclical impact of mark-to-market accounting.

6.45 In addition, in the UK, the FSA has taken steps in its implementation of the Capital Requirements Directive (which implements the Basel II accord into EU legislation) to ensure any pro-cyclical impact is minimised as far as is compatible with maintaining a risk sensitive approach. This was clarified in the FSA's statement on its regulatory approach to bank capital.[6]

Building counter-cyclical buffers in good times

6.46 In addition to checking that regulatory standards do not encourage pro-cyclical behaviours, the Government believes that policy needs to go further than this, ensuring that regulation encourages firms to build up of buffers of resources during the economic expansion in order to enable firms to absorb subsequent losses without triggering or amplifying an economic downturn. G20 leaders have committed to this objective, and the Basel Committee is developing detailed policy options.

6.47 A leading option, dynamic reserving or provisioning, would involve estimating and applying long-run expected losses on assets rather than actual current loan losses. This means that banks will in effect hold more reserves in the good times when actual loan losses are below the long-run average. As a result, banks would build a buffer during times of economic expansion, on which they would be able to draw upon when conditions deteriorate.

[6] *FSA Statement on regulatory approach to bank capital*, Financial Services Authority, January 2009 (available from www.fsa.gov.uk)

6.48 Counter-cyclical buffers can be created through provisions against loans or as capital reserves. The Government believes that such rules should be introduced primarily through adjustments to prudential regulation rather than accounting standards. This is discussed further in Box 6.B.

Box 6.B: Accounting or prudential mechanisms to build buffers in good times

The Government supports the adoption of mechanisms to encourage financial institutions' use of counter-cyclical buffers. These buffers can be in the form of provisions or capital. Provisions against loans (termed dynamic provisioning when done systematically to build provisions that act in a counter-cyclical manner) are deducted from profits during the upswing, and held on the balance sheet as liabilities. Currently, only incurred losses may be deducted but the IASB is considering the extent to which expected or forward looking losses can be deducted.

There are challenges to designing effective policies to build counter-cyclical buffers, since calculating expected losses requires assumptions about the future on ambiguous evidence. Particular issues arise if provisions are used. Requiring counter-cyclical buffers entirely through provisions would place this burden on the shoulders of accounting standard setters, and they may not be best-placed to make the appropriate assessments. Giving too much flexibility over provisioning decisions to individual banks raises potential problems about transparency in this aspect of financial reporting.

A preferred approach is likely to include a combination of provisioning and capital reserving, with the latter implemented under the aegis of prudential regulators. The Government supports the proposals in the Turner Review that buffers be held in the form of non-distributable reserves, set by prudential regulators, which would be transparently disclosed in the published accounts in accordance with accounting standards. This would aim to ensure the building of counter-cyclical buffers as required by financial stability, while maintaining the integrity and transparency of financial statements.

Supervisors must accommodate the legitimate objectives of accounting standard setters when making proposals for counter cyclical buffering. Accounting standard setters must take full account of supervisory practice when setting and adapting standards. The Government will work with both international standard setters and regulators to develop and agree integrated policy options that address pro-cyclicality, while upholding the accounting framework.

6.49 While there are encouraging signs that these measures will help make banks more resilient to shocks, the clear lesson from past changes to capital ratios is that they can produce distortions which reduce their overall effectiveness. If banks hold more capital than they deem commercially desirable in an upturn then there is a risk that they will put this capital to use through assuming greater risks rather than holding it as a real buffer that can be used in a downturn. Therefore a full assessment will be required before introducing policy measures.

6.50 International discussions about mitigating pro-cyclicality have focused primarily on ensuring banks are more resilient to shocks, and to a lesser extent on the objective of mitigating the tendency for financial markets to amplify economic cycles. The Government believes that international work to develop regulatory mechanisms to mitigate pro-cyclicality should focus to a greater extent on preventing the build-up of imbalances through excessive leverage and asset price growth. Policy options include linking capital requirements to indicators of risks in the

financial sector or wider economy and firm-specific indicators such as the growth in individual banks' lending activities or their liquidity profile.[7]

Improving access to funding in down times

6.51 An important transmission mechanism during financial crises is the vulnerability of funding markets. When the cycle turns and banks make losses and so seek to raise new capital, liquidity can evaporate and the cost of funding increases. The only course of action is for banks to reduce their exposure to other banks and to their customers. Part of the problem is that banks have difficulty convincing investors that they are declaring the full extent of the problems they face.

6.52 To improve the functioning of funding markets there is a clear case for more transparency of bank exposures as discussed earlier in this chapter. Additionally, ideas are increasingly being discussed that are aimed at ensuring that banks have better access to capital in economic downturns. These are discussed in Box 6.C.

Box 6.C: New international ideas for improving access to funding markets

Two ideas to improve banks access to capital during downturns or crises are being aired in academic and policy circles. Both have merits although how they could be applied in practice is yet to be determined.

Capital insurance:[8] banks essentially face an insurance problem: when faced with a shortage of capital, rather than having to raise new capital at a high market cost it would be more efficient if banks were delivered capital at a pre-agreed (lower) price though a pre-funded insurance policy. Paying the insurance premium in an expansion would be one method of providing some cost to the expansion of credit in an upturn. However, in a systemic crisis the insurance policy would need to pay out to several banks together. In order to ensure that these obligations could always be met, the insurance would probably need to be run by the state sector.

Debt-equity conversion:[9] when banks are forced to raise new equity capital the initial benefits are shared with the existing debt holders as they have a senior claim over equity in the event of liquidation. One solution would be to make some of the debt (perhaps the subordinated debt tranche only) convertible into equity in the event of a systemic crisis and on the authority of the financial regulator. This would immediately inject capital into the bank and reduce the need to raise any new equity capital. The holders of the debt would also have more incentive to impose market discipline on the banks.

Discretionary tools to lean against credit cycles

6.53 As discussed above, leaning against the credit cycle can be achieved in part through the implementation of appropriate rules-based regulatory mechanisms agreed internationally. There are clear advantages to rules-based approaches. If they are allowed discretion, authorities face time consistency problems where they cannot commit in advance to behave consistently.

[7] The FSA has proposed the introduction of a core funding ratio. This would impose a limit on the ratio of core funding, i.e. sources of funding that are particularly reliable and therefore sustainable throughout the economic cycle, to total funding. The FSA has suggested that core funding could include, for example established retail deposits and long-term wholesale funding. Such a rule would act to constrain the tendency for banks to become increasingly reliant on less stable sources of funding as they expand their balance sheets. This would in turn help to lean against excessive growth in aggregate credit availability during economic expansions.

[8] See *The credit crisis: conjectures about causes and remedies (NBER Working Paper No. 14739)*, Douglas Diamond and Raghuram Rajan, February 2009

[9] See "Building an incentive-compatible safety net", C. Calomiris, in *Journal of Banking and Finance*, 1999

6.54 However, financial institutions are adaptive and innovative, so any rules-based approaches may not be enough on their own. Regulation can also alter incentives in unintended ways. For example, they may even inadvertently lead firms to channel activity into more lightly regulated sectors and so undermine the intended effectiveness of regulation.

6.55 If authorities are to be effective at mitigating the build up of aggregate risk in the financial markets and wider economy they will need to be able to make judgements about how risks are evolving over time and to respond with discretionary instruments as well as rules. For these reasons the Government believes that effectively constraining the inherent pro-cyclicality of financial markets will require an element of discretion.

Official communication

6.56 If policymaking takes greater account of asset prices and financial imbalances, the authorities will be able to express any concerns they have to the private sector. In turn, verbal and written interventions could arguably play an important role in shaping expectations and discouraging destabilizing behaviour. For example, the Bank of England could be more explicit in warning about potential unsustainable developments in asset prices in support of both its monetary policy and financial stability objectives. The new Council for Financial Stability would play a key role in this, with its minuted discussions encouraging public debate and scrutiny of the risks highlighted and the authorities' response to them, which should in turn influence market participants' behaviour.

Varying regulatory settings

6.57 The challenge, of course, will be to find a way to make these warnings credible. In addition to ensuring that the framework of regulation is flexible enough to respond to financial innovations, the Government, through the new CFS, will ensure that the Authorities work together to assess whether changes to other policy instruments, particularly regulatory instruments, are necessary to lean against unsustainable growth in aggregate risk in the financial system. This could involve, for example, introducing or resetting leverage ratios or macro-prudential add-ons to regulatory capital requirements in response to the emergence of threats to financial and macroeconomic stability.

6.58 The Government will work closely with the FSA and the Bank of England as well as international partners to develop mechanisms for monitoring the build up of systemic risks, and macro-prudential tools to respond to such risks.

6.59 As discussed in Chapter 4, the Government has played a leading role in international efforts to identify new rules or policy instruments to help the authorities worldwide smooth the impact of credit conditions on the business cycle more effectively. The London Summit of the G20 set out a broad programme of work, which international bodies are taking forward urgently.

6.60 With global financial markets and institutions, these measures can only be effective if implemented on a broad international basis, and it will be some time before consensus is reached. Institutional responsibility for any new tools implemented by the Government in the UK will be considered once international agreement has been reached on what the new tools should be, and how they are to be used.

Loan to value ratios

6.61 Policy proposals have also been floated that would regulate the characteristics of financial products rather than the behaviour of financial institutions. In particular, there have been calls to consider imposing limits on loan to value ratios in the event of the emergence of unsustainable growth in house prices. Recent years saw a rise in the proportion of mortgage products with 100 per cent or more loan to values (LTVs). It is sometimes argued that high LTV

lending implies significant risks for lenders and consumers, who may be relying on rising property prices to reduce risks.

6.62 The Government asked the FSA earlier this year to consider the treatment of mortgages of more than 100per cent of house value. The FSA will publish a paper in October that will consider potential options for regulatory reform. As part of this, the FSA will consider the extent to which high LTV loans are correlated to customer defaults and bank losses, taking into account wider issues, including access to homeownership and the availability of unsecured credit in the market.

Interest rates

6.63 Since the early 1990s, many central banks around the world have targeted price stability, often in addition to having a financial stability objective. For example, the Bank of England has an explicit target for consumer price inflation and adjusts Bank Rate in an attempt to keep inflation close to this target. But, as the steep fall in output seen in the UK and other advanced economies demonstrates, a framework that delivers price stability does not necessarily protect economies from the impact of events such as the global financial crisis.

6.64 Some economists believe monetary policy should focus on a wider set of 'macro-prudential' objectives, such as asset prices or credit growth. In general, there is no consensus about what form these objectives should take and what their policy consequences might be. One of the more radical recommendations is that central banks should incorporate asset prices into their inflation targets. For example, in addition to an inflation target, policymakers could attempt to keep a basket of asset prices close to some measure of their 'fundamental value'.

6.65 However, there are significant practical problems associated with using short-term interest rates to pursue 'macro-prudential' policy goals. In terms of explicit asset-price targets, these problems are widely documented in the academic literature and explain why monetary-policy makers have conventionally avoided such objectives.[10] The most commonly cited of these problems involves identifying unsustainable trends in real time. However, there are also other potentially prohibitive practical issues:

- first, monetary policy would have two objectives (price stability and avoiding financial imbalances) but only one policy instrument (interest rates). This could create policy tensions if the two targets moved in opposite directions; and
- second, short-term interest rates may be an inappropriate instrument with which to 'lean against' asset prices. At the height of a speculative boom, when asset prices are growing rapidly, investors expect large gains. In such an environment, a modest rise in interest rates is unlikely to have a significant impact on investors’ expected returns and therefore aggregate asset prices. This means that it might be difficult for the central bank to burst the asset-price bubble without having to raise interest rates significantly, with serious macroeconomic consequences.
- finally, the asset-price trends and credit expansion of the past decade have been global in nature. For example, in the context of rapidly rising global asset prices, raising interest rates might have only a limited impact on domestic financial conditions if other central banks have kept interest rates low. This complicates how a central bank can respond to them, particularly in an open economy like the UK.

[10] See for example *Asset-price "bubbles" and monetary policy: remarks by Governor Ben S Bernanke before the New York chapter of the National Association for Business Economics, New York*, Federal Reserve Board, October 2002 (available from www.federalreserve.gov)

6.66 Given these practical problems, and the Bank of England's success over 12 years in keeping inflation close to target, the Government does not believe it needs to change the Bank of England Monetary Policy Committee's remit by adding explicit macro-prudential objectives. The Monetary Policy Committee should continue to use Bank Rate to target consumer price inflation.

6.67 There is ongoing work by Eurostat and national statistical authorities to include a measure of owner occupied housing costs in the CPI (the measure of inflation used as the Bank of England's inflation target). Alongside this, the Office for National Statistics (ONS) is also looking at ways to incorporate housing costs into the CPI. The Government welcomes this analysis.

6.68 The existing framework does not exclude taking a flexible approach to the inflation target. Financial developments play a central role in setting monetary policy in the current framework because of the implications for the inflation outlook. However, it has been noted that the impact of some developments may only be felt in the longer term. The current framework allows these to be taken into account by the fact that the inflation target applies at all times.[11]

Delivering a new regime for systemic risk

6.69 The analysis of the financial crisis in chapter 3 describes the links between the financial system and the wider economy. The crisis has demonstrated how the accumulation of systemic risk across financial markets can have serious macroeconomic consequences.

6.70 This has implications for economic policy making. There is broad international consensus that central banks should be independent and should pursue stable inflation, and that regulators should pursue risk-based micro-prudential regulation. But because of the links between financial and macroeconomic stability they need to work closely together to ensure macroeconomic stability. Financial markets can clearly amplify the economic cycle with possibly significant fiscal and economic costs to follow.

6.71 The tools discussed above aim to mitigate these adverse consequences for financial and macroeconomic stability of the pro-cyclical behaviour of financial institutions and markets. But further analysis is needed to determine how these tools would influence the behaviour of financial institutions over the cycle before they can be implemented.

6.72 The Government will work with the FSA and the Bank of England and international counterparts to analyse fully the impact of each of these potential tools on the wider economy.

6.73 Moreover, it is in practice difficult to identify unsustainable macro-financial trends, such as asset price bubbles and excessive credit growth, in real time. Variations in aggregate leverage in the financial sector need not necessarily prove to be pro-cyclical if they reflect structural changes allowing the system as a whole to support more leverage. Similarly, strong growth in asset prices per se does not prove the existence of a bubble.

6.74 As discussed in Chapter 4, the new CFS will play an important role in coordinating the work of the regulatory authorities in responding to the challenges of managing systemic risk, both in the UK and internationally. International work is also under way in the FSB to develop a set of indicators to monitor macro-financial trends such as the build up of leverage in the financial system. As well as working with international partners, the Government will work closely with the Bank and FSA to develop a framework for monitoring and assessing the build up of aggregate risk in the financial markets and wider economy.

[11] As Charles Bean points out: "the implications of possible imbalances and misalignments for the macroeconomic goal variables must necesssarily be factored into the assessment of expectations of future growth and inflation". See *Asset prices, financial imbalances and monetary policy: are inflation targets enough? (BIS Working Papers No 140)*, Charles Bean, Monetary and Economic Department - Bank of International Settlements, September 2003, p.18 (available from www.bis.org)

Summary

6.75 It is clear that regulators and central banks need to work together to look at the financial system as a whole, in order to effectively manage systemic risk across markets, dampen excessive credit growth and excessive risk-taking in the financial system which can amplify an economic upturn; and ensure that banks are more resilient to economic shocks when they occur to prevent them from amplifying an economic downturn.

6.76 This chapter examined the tools the authorities may use to achieve these objectives. Clearly, these tools would need to be developed and agreed at an international level and implemented in a standardised way in order to avoid jurisdictional and regulatory arbitrage. The UK will work closely with its international counterparts and institutions to achieve this, as set out in the next chapter.

7 International and European cooperation

The scale, complexity and cross-border nature of firms and their activities present particular challenges to national authorities in preventing, managing and resolving crises in financial markets.

Recent challenges have demonstrated the need for strong domestic regulatory systems to be complemented by enhanced supervision of international firms and markets through robust international standards, closer cooperation between authorities, and a more coherent international regulatory architecture.

The G20 under the UK's chairmanship has taken important steps to strengthen the international regulatory architecture and shape the future regulatory agenda. The G20 agreed that strong domestic regulatory systems are the bedrock of a well-functioning financial system. But leaders also committed to establish much greater consistency and systematic cooperation between countries, and a framework of internationally agreed high standards. The UK is determined to ensure the successful implementation of those agreements domestically and internationally.

In the area of systemic or macro-prudential regulation, the G20 countries have committed to make sure that all systemically important institutions, markets and instruments are subject to appropriate regulation and oversight. Chapter 6 set out the steps the Government is taking domestically to ensure that systemic risk is identified and mitigated effectively. But the design and implementation of these measures must be coordinated at international and EU level in order to maximise their effectiveness and reduce the risk or jurisdictional and regulatory arbitrage.

This chapter sets out the changes that are being put in place:

- to enhance sound domestic regulation globally;
- to strengthen the international regulatory architecture; and
- to strengthen regulation and supervision in Europe.

In addition, we examine the areas where more can be done to strengthen regulation and international cooperation:

- Europe has a major contribution to make in reinforcing the international regulatory architecture. Europe needs to strengthen financial stability and the single market with a focus on more common rules, closer cooperation between supervisors and establishing a way to resolve disputes between home and host supervisors. Europe should act quickly to strengthen its regulation, in line with the decisions taken at the June European Council;
- we will sharpen and strengthen the FSA's international focus by giving the regulator new duties to work internationally;
- the UK is encouraging all countries to take action to update resolution and crisis management mechanisms to deliver similar outcomes to those introduced by

the UK under the Banking Act.

Enhancing sound domestic regulation globally

7.1 The globalisation of financial markets has increased rapidly in recent decades. It has become easy for financial firms and markets to operate across borders, which has led to the emergence and importance of large, complex financial institutions operating on an international scale. Financial integration can bring benefits for financial stability as risk is diversified more widely, and it can increase prosperity as new markets develop.

7.2 However, the growing importance of cross-border firms and markets also brings with it challenges for financial stability and for the authorities with responsibilities for it. The scale, complexity and cross-border nature of firms and their activities – straddling national boundaries, legal jurisdictions and supervisory remits – present particular challenges to national authorities in preventing, managing and resolving crises in financial markets. These issues have been highlighted by the financial crisis and have demonstrated the need for strong domestic regulatory systems to be complemented by enhanced supervision of international firms and markets through robust international standards, closer cooperation between authorities, and a more coherent international regulatory architecture.

7.3 The UK has been at the forefront of international and European debates on regulatory reform and has used its chairmanship of the G20 and membership of other international bodies to reform financial regulation and supervision. At the London Summit in April, G20 leaders acknowledged that failures in the financial sector and in financial regulation and supervision were fundamental causes of the financial crisis. The G20 agreed that strong domestic regulatory systems are the bedrock of a well-functioning financial system. But leaders also committed to establish much greater consistency and systematic cooperation between countries, and a framework of internationally agreed high standards, that a global financial system requires.

7.4 Building on, and responding to, the actions set out at the Washington Summit in November 2008, the G20 under the UK's leadership agreed major reforms based on the principle of strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets and reinforcing international cooperation. In particular, the G20 agreed:

- to establish a new Financial Stability Board (FSB) with a strengthened mandate, as a successor to the Financial Stability Forum (FSF), including all G20 countries, FSF members, Spain, and the European Commission;
- that the FSB should collaborate with the IMF to provide early warning of macroeconomic and financial risks and the actions needed to address them;
- to reshape regulatory systems so that authorities are able to identify and take account of macro-prudential risks;
- to establish supervisory colleges for cross-border firms and to implement the FSF principles for cross-border crisis management;
- to extend regulation and oversight to all systemically important financial institutions, instruments and markets. This will include systemically important hedge funds;

- to endorse and implement the FSF's new principles on pay and compensation and to support sustainable compensation schemes and the corporate social responsibility of all firms;
- to take action, once recovery is assured, to improve the quality, quantity, and international consistency of capital in the banking system and agree a global framework for promoting strong liquidity buffers in financial institutions;
- to take action against non-cooperative jurisdictions, including tax havens;
- to call on the accounting standard setters to work with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards; and
- to extend the regulatory oversight and registration to credit rating agencies to ensure they meet the international code of good practice.

7.5 These commitments will help promote propriety, integrity and transparency and guard against risk across the financial system. Recent agreements also demonstrate a renewed commitment to protect consumers and investors; support market discipline; reduce the scope for regulatory arbitrage; and keep pace with innovation in the marketplace.

7.6 The UK will be working with the international community in the coming months to provide specificity to some of the outstanding proposals to strengthen regulation. In particular, detailed technical work will be undertaken in the areas of capital, accounting, liquidity and pro-cyclicality to ensure that regulation strengthens the resilience of financial institutions to future financial shocks. Many of these changes will need to be agreed internationally to avoid encouraging cross-border arbitrage. They will also not be introduced until a full economic and financial recovery is assured.

7.7 In turn, the effectiveness and durability of the commitments described above is dependent on implementation by national and regional authorities. Delivering these agreements may require governments to amend their regulatory systems through legislation, and will require a step change in the way supervision is managed. The FSB will produce its first report to G20 Finance Ministers and Central Bank Governors in September setting out progress made in developing policies agreed in London, and countries' implementation of commitments. The UK will be calling on its international partners at forthcoming international meetings to ensure that they implement these agreements in a timely manner.

Strengthening the international regulatory architecture

7.8 The FSB will be at the centre of the new international regulatory architecture bringing together supervisors, policymakers and standard setters to advise on and monitor best practice in meeting regulatory standards. The Government agrees with the recommendation made in the House of Lords report on Banking Supervision and Regulation (May 2009) that the FSB must be sufficiently independent and well-resourced to provide international monitoring of financial stability, and to disseminate credible recommendations to national governments and regulatory bodies. The UK will use forthcoming international meetings to ensure that the institutionalisation of the FSB is swift and effective.

7.9 The UK envisages the newly reformed FSB operating at the centre of the international regulatory architecture, drawing on its diverse membership of international financial institutions, standard setting bodies, the European Commission, and national authorities to ensure consistency and coherence in the development and application of financial regulation. In order for the FSB to play this full role it must oversee the enforcement of standards and scrutinise its

members' adherence to international standards. Members of the FSB – existing and new – have committed to implement international financial standards and to undergo periodic peer reviews

7.10 . The UK is amongst the first countries that have already committed to undertaking an IMF/ World Bank Financial Sector Assessment Program (FSAP) review, and is encouraging all countries that have not yet done so to commit to participating in an FSAP in the near future. The FSB's new review and enforcement role will be critical in ensuring a level playing field, reducing the scope for regulatory arbitrage, and upholding high standards over the long-term.

7.11 The new international regulatory architecture will also give the wider international community greater clarity regarding best practice in international prudential regulatory and supervisory standards, and provide authorities with a benchmark against which to address the performance of other jurisdictions' performance. To begin this process, the FSB and the IMF will provide reports in September setting out compliance with these international standards and will propose a toolbox of measures to promote non-cooperative jurisdictions' adherence to prudential standards and cooperation.

Strengthening regulation and supervision in Europe

7.12 Europe needs a well-regulated, dynamic and globally competitive financial sector. The UK has and will play a key role in shaping the reform of the EU's financial regulatory architecture.

7.13 Europe's single market is in many areas underpinned by a strong regulatory framework. However the crisis has identified some weaknesses and gaps in this framework where action is needed. First, the ability to identify systemic risks within the EU needs to be improved. Second, it is now necessary to improve the quality and scope of rules applying to firms, and to ensure their proper enforcement.

7.14 The European Council, in response to the de Larosiere report and recommendations from the European Commission, has recently agreed a far-reaching package of reforms to strengthen EU supervisory and regulatory architecture. The Government welcomes the European Council Conclusions in June 2009 in this area, which give a clear direction and framework for the legislative negotiations ahead.

7.15 The Government believes that Europe's ability to identify macro-prudential risks needs to be enhanced to secure financial stability. The Government therefore supports the agreement at the June 2009 European Council to create a new European Systemic Risk Board (ESRB). This would complement the international model prepared by the IMF and FSB, which assesses macro-financial risks and proposes policy responses, by focusing in a greater level of detail on the situation in Europe. The ESRB could assess the build up of risks within the EU, the EU's exposure to vulnerabilities and trends in the global economy, and actions that European institutions and Member States could take to mitigate and address these risks.

7.16 In turn, the ESRB's detailed analysis may also inform the international Early Warning Exercise.

7.17 The Government strongly supports steps to improve the quality of regulation, and its enforcement. This fits alongside the comprehensive global agenda, as described in previous sections, to improve capital and liquidity standards. The EU needs to apply its expertise to those discussions, and work internationally to secure global standards. These must then be implemented through European legislation, without derogations. This also will require fewer national discretions in EU legislation and a European single rulebook. The current set-up, where different options for the same regime mean that groups face different capital rules from different European supervisors, is no longer acceptable. It undermines the effectiveness of regulation and must be bridged if national supervision is to be applied consistently and

effectively across the EU. The establishment of the new European Supervisory Authorities, agreed at the June European Council, should expedite this process.

7.18 It is also clear that the scope of regulation itself needs extending, as agreed by the G20. The EU has already taken steps to register credit rating agencies for regulatory purposes. European work is under way to bring more over the counter securities contracts onto central counter parties (CCP) for clearing and settlement. Work is also needed to establish European operational and prudential rules for CCPs. In addition, it is necessary to look at the tools and safeguards available to deal with cross-border banks, in particular branches (see Box 7.A below). Without such protections the EU risks undermining support for the branch-based model and financial integration more widely.

7.19 Alongside improvements to EU regulation, it is critical that we ensure that these rules are properly enforced, including through better quality supervision. The Government is strongly supportive of the establishment of supervisory colleges, combined with supervisory audit, peer review and home-host mediation. These all have the potential to improve the quality of supervision and will ensure that national supervisors apply the strengthened regulatory structure, together with a mechanism for binding mediation to resolve disputes between home and host supervisors. The EU should press forward and implement these in legislation.

7.20 Beneath this, the Government welcomes and strongly supports the general EU consensus that day-to-day supervision of firms should remain national, both to ensure high quality supervision and to reflect the clear link to any provision of fiscal support to firms. Consistent with the conclusions of the June European Council, the EU will need to ensure that decisions taken by the new European Supervisory Authorities will not impinge in any way on national fiscal responsibilities. That said, whilst recognising that supervisory arrangements need to protect national taxpayers, the UK will work to ensure that supervision is effective at national, EU and global levels, especially in the case of financial institutions that operate across borders.

7.21 Prior to the establishment of the new European Supervisory Authorities, the Government also believes that we need to ensure additional resources for the current Level Three committees now. These have important work to do, including on facilitating the registration of CRAs and on level 2 measures for the Solvency II Directive. It will be important to swiftly implement what has already been agreed rather than wait until the proposed new supervisory authorities are created. In the longer term, the Government believes there is merit in having a single rule making body in the EU to improve the quality of regulation.

Box 7.A: Branches and the European Union

The global financial crisis has raised questions about the adequacy of the rules and safeguards protecting EU Member States that play host to branches of foreign banks operating under an EEA passport. For example, there were serious problems due to failures in the supervision of Icelandic banks by the home State, and inadequacies of the home State deposit guarantee scheme. A number of European workstreams considering how to enhance the existing home and host arrangements will make recommendations on cross-institutional and supervisory reform.

The Government has called for action to give supervisors of significant cross-border branches all the supervisory information commensurate with the risks that a cross-border branch poses, and has supported a review of the risks and safeguards around cross-border branching models. The Government considers that the rules and safeguards for cross-border branching within the EEA should be strengthened to:

- reduce the likelihood of failure; and
- reduce the cost of failure.

This could be achieved, for example, by ensuring that minimum supervisory standards are strong and applied consistently to cross-border groups; information exchange between home and host authorities is strengthened, with host supervisors having access to micro-prudential information relating to the overall financial position of a group; and that peer review and supervisory audits of cross border supervision take place. Establishing the proposed new European Supervisory Authorities will be an important first step towards improving the system.

In addition, the FSA is developing a new liquidity regime, and have published a number of consultations. The new regime would apply the principle that a UK-regulated firm, including UK branches of foreign firms, should be self-sufficient for liquidity purposes, unless its parent company meets certain criteria.

To reduce the cost of failure, the Government believes that Member States should have minimum and compatible resolution toolkits – adopting regimes that are along the lines of the UK's Banking Act; developing and agreeing winding down plans for significant cross-border groups; and establishing cooperation agreements between deposit guarantee schemes to enhance their operational effectiveness. Such resolution plans would also be desirable on a global basis.

Strengthening the FSA's international focus

7.22 The Government is committed to ensuring that its regulatory system is robust, keeps pace with future challenges, and supports financial stability. The recent crisis has highlighted the extent to which developments in financial markets can have spillovers across national boundaries, and the importance of effective international cooperation in responding to crises. International engagement has intensified over the last 18 months with greater communication and cooperation between regulators, international standard-setting bodies, and regulatory organisations, and coordinated action on the part of central banks and governments. These interactions have been bolstered by recent agreements to strengthen the international regulatory architecture.

7.23 In light of these changes, the Government believes that it is important to reaffirm the authorities' responsibilities towards international policy-making. The FSA and the Bank of England play an important role in informing international regulatory debates and negotiating

regulatory policy. The FSA, often in conjunction with the Bank of England, is a member of the main regulatory bodies including the Financial Stability Board (FSB), the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), and the International Accounting Standards Body. The FSA also plays a supporting role in EU negotiations and is a member of each of the Level Three Committees in the EU.

7.24 The Treasury, Bank of England and FSA have collaborated closely throughout the crisis. But in light of developments at the international and European level, it is important to reaffirm the authorities' roles, establish mechanisms to help ensure that the authorities speak with a common voice in international fora, and continue to give appropriate attention to regulatory debates. To deliver these objectives, the Government intends to give the FSA an explicit international duty that would complement the Government's and the Bank of England's responsibilities.

7.25 The new statutory duty would require the FSA to promote sound international regulation and supervision. This would include representing the UK's interests in international fora, and in doing so have regard to international best practice and maintaining the competitiveness of the UK financial services industry.

7.26 As discussed in Chapter 4, the Government is also intending to legislate to provide the FSA with a new financial stability objective. The financial stability objective will also require the FSA to take into account the impact of international developments on financial stability in the UK. The Capital Requirements Directive currently being negotiated within the EU could also have implications for the way in which the FSA approaches financial stability.

International cooperation and cross-border supervision

7.27 Sound domestic regulatory systems are the bedrock of a well-functioning financial system. But the global nature of financial markets and firms requires effective cooperation and coordination between countries to strengthen stability and resilience in the financial system, reduce the likelihood and impact of cross-border firms facing difficulties, and provide effective protection for consumers and depositors. Cross-border cooperation needs to be addressed on a number of levels and in different fora, including ensuring that international and EU approaches are aligned.

7.28 The UK has been at the forefront of progress made at the international level towards enhancing cooperation. In particular:

- supervisory colleges have been established for the largest cross-border firms;
- the UK and other G20 countries have committed to implement the FSF principles for cross-border crisis management and agreed that the home authorities of each major international financial institution should ensure that the group of authorities with a common interest in that financial institution meet at least annually;
- the IMF and FSB launched an initial Early Warning Exercise at the 2009 Spring Meetings to identify macro-financial vulnerabilities and propose policy responses.

7.29 The establishment of supervisory colleges for all major firms will lead to a better understanding of the full extent of firm-specific risks, whereas the creation of cross-border crisis management will improve information sharing between the authorities in different countries, addressing macro-prudential risks and possible cross-border spill-overs.

7.30 The UK is committed to ensuring that these cooperation mechanisms are and continue to be useful and relevant. This means that colleges and cross-border crisis management arrangements must be kept under review to ensure that the largest most complex firms are

covered by such arrangements, even during periods of stability. The Government believes that the successor bodies to the Lamfalussy Level Three committees, as recently proposed by the European Commission, should, like their predecessor bodies, have a strong role in providing operational guidelines to supervisory colleges and promoting best practice.

7.31 The recently launched IMF/FSB Early Warning Exercise (EWE) should become an important part of the new global system of macro-prudential surveillance. The EWE is designed to better integrate regulatory and supervisory responses into the macro-prudential policy framework, with the IMF identifying and prioritising systemic macrofinancial risks, and the FSB proposing policy responses, and collectively reporting to policymakers. The EWE should enable policymakers to respond to and mitigate potential risks and vulnerabilities in the economic and financial system before they fully materialise. The IMF and FSB will need to nuance the approach they took to the pilot EWE to ensure that it becomes an effective surveillance tool. As the recent House of Lords report on Banking Supervision and Regulation states, notwithstanding the difficulties at the international, or even European level, international macro-prudential supervision should be encouraged.

7.32 In order to meet this objective, the Government proposes that the IMF and FSB should:

- draw upon the relative strengths of each institution. It is vital that the FSB is a full partner in the EWE and uses its expertise to propose appropriate regulatory responses to the macro-financial risks identified by the IMF;
- identify both quantitative and qualitative assessments of risks focusing on those with potential cross-border effects;
- have a clear signalling system based on the likelihood and impact of a possible event;
- be a forum for articulating concrete policy responses to risks identified, particularly those that require coordinated as opposed to unilateral action; and
- draw on risks and advice identified in other appropriate reports.

Crisis management

7.33 The failure of a bank can have significant consequences. In the absence of special arrangements there is a risk that depositors might be deprived of access to their accounts, and that problems may spread to the wider banking system. The forms of international cooperation set out earlier in this chapter will help prevent a bank ever reaching this situation, but there will always remain a risk that banks will fail. It is important to ensure that there are appropriate legal and other arrangements in place to deal with such circumstances. The UK has introduced a special resolution regime as part of the Banking Act 2009 to provide the relevant tools to deal with this sort of situation.

7.34 The responsibility for such arrangements falls on national authorities to reflect national characteristics, such as the shape of the local banking market and legal systems. However, it is important to ensure that international rules facilitate rather than hinder appropriate action by national authorities, and that there is international consistency in approaches to cross-border bank resolution arrangements.

Summary

7.35 As set out in each of the preceding chapters of this strategy document, the financial crisis was international in nature, caused by globalised trends in the operation of financial markets and their regulation. Therefore, the response to the crisis must be globally co-ordinated. This chapter has set out reforms and changes that are already being made, through the work of EU

and international fora – notably the G20 – in addition to key areas where further international work is needed.

7.36 Our central objective is to ensure that, as we come through this crisis, we create a sound and efficient financial system, both in the UK and globally, that works for consumers and businesses, by restoring public confidence in the banks, containing the risks to the wider economy, and encouraging responsible lending. The next chapter sets out the measures the Government will take to protect and support consumers of financial services, including measures to improve financial capability, improving access to simple, transparent products and enabling consumers to obtain collective redress in the case of widespread complaints.

8 Supporting and protecting consumers

The global financial crisis has inevitably led to significant disruption to the operation of financial services. This disruption has the potential to cause firms to become disconnected from their customers; particularly as ordinary individuals and small businesses, who rely on their banks for the provision of essential day-to-day services, have lost trust in these firms.

This strategy sets out action being taken by the Government to make financial services work better for consumers, supporting and protecting them through:

- measures to raise financial capability;
- improving access to simple, transparent products;
- enabling consumers to take group or representative action to obtain collective redress in the case of widespread complaints; and
- improving the arrangements for depositor protection.

These measures are accompanied by the Government's action set out in the paper "A fair deal for consumers: delivering real help now and change for the future" which was published on 2 July 2009.

8.1 The global financial crisis has led to disruption of financial services and markets at all levels. Problems in wholesale markets have placed serious pressure on banks and other firms. Just as serious, however, has been the effect of this on retail financial services customers – ordinary people and small businesses who rely upon their banks for the provision of essential day-to-day "utility" services such as keeping their money safe, making payments quickly and securely, and managing their finances.

8.2 While Government action to keep credit flowing through the economy has had a positive impact, many such customers have found it harder to get access to finance – whether a mortgage to buy a house or a small business overdraft to provide essential working capital. There can be no doubt that trust in banks has been affected by the crisis: the prospect of a bank failing, which would have seemed unthinkable two years ago, has become a reality.

8.3 The Government has recognised the importance of making sure that the consumer perspective is not lost as it takes action to tackle the crisis. As announced in the 2008 Pre-Budget Report, the Government set up the Retail Financial Services Forum (RFSF), on which the financial services industry, consumer groups and regulators are represented alongside the Government. The RFSF has a remit to champion retail consumers' interests and help restore confidence in financial services. The Government has asked the RFSF to steer the development of some of the proposals set out in this chapter. It will also identify and take forward other measures to help restore consumer confidence.

8.4 There are two crucial aspects to this important consumer agenda:

- first, consumers must be given the support they need to access and select the products and services they require in the modern economy; and
- second, they must have complete confidence in the processes that are put in place to make sure that, in the unusual event of a firm failing its customers – either through its conduct, or through a corporate failure – they are protected and compensated quickly and effectively.

Supporting consumers access the financial services they need

8.5 This section sets out action that the Government is taking in four core areas:

- supporting the financial capability of consumers, so that they can make the right choices for themselves, and have access to help in doing so;
- making sure that simple and transparent products are available for those who need or want them;
- ensuring that people have access to essential financial services, through the Government's strategy for financial inclusion; and
- focusing on the important issue of mortgages and consumer credit.

Financial capability

8.6 The Government is committed to the vision of better-educated consumers who have the skills, motivation and confidence to make informed and responsible financial decisions. The Government set out its long-term aspirations for financial capability in 2007:[1]

- that every child in the UK should have access to a planned and coherent programme of personal finance education in school;
- that every adult in the UK would have access to generic financial advice (now called 'money guidance'); and
- financial capability should be promoted through a series of Government programmes.

8.7 Progress in delivering these aspirations was reported as part of a joint Government/FSA action plan for financial capability, published jointly by the Government and FSA in July 2008.[2]

8.8 Financial capability is now a dedicated strand of Personal, Social, Health and Economic (PSHE) education in the secondary curriculum in England. The Government is currently consulting on plans to put PSHE on a statutory footing.[3] The £11.5 million *My Money* programme is embedding financial education in schools, with links to the Child Trust Fund. The devolved administrations are making similar curricular changes, ensuring that children across the UK will benefit from personal finance education in school.

Money Guidance

8.9 In January 2007, the Government commissioned Otto Thoresen to conduct a feasibility study into making impartial generic financial advice on a wide range of personal finance issues accessible to all, while targeting those most vulnerable to the consequences of poor financial

[1] *Financial Capability: the Government's Long-Term Approach*, HM Treasury, January 2007 (available from www.hm-treasury.gov.uk)

[2] *Helping you make the most of your money: a joint action plan for financial capability*, HM Treasury and Financial Services Authority, July 2008 (available from www.hm-treasury.gov.uk)

[3] *Public consultation on curriculum reform, Qualifications and Curriculum Authority*, April 2009 (available from www.qca.org.uk)

decision-making. The Thoresen Review set out a blueprint for a Money Guidance service in its final report in 2008.[4]

8.10 The Thoresen Review recommended that this blueprint should be tested through a large-scale pilot or 'pathfinder' ahead of national rollout. The £12m pathfinder, jointly funded by the Government and the FSA, launched in the North East and North West of England on 14 April 2009. It aims to reach between 500,000 and 750,000 people by spring 2010.

Box 8.A: The Money Guidance pathfinder: real help now for consumers in the North West and North East England

Since April this year, people in the North West and North East of England have been able to get information and personalised guidance on a wide range of personal finance issues through a pathfinder money guidance service called *Moneymadeclear.* This service offers impartial help that consumers can trust, safe in the knowledge that *Moneymadeclear* advisors will never try to sell them anything. People can access the service in a way that suits them – through the website or by speaking to trained advisors on the phone or face to face, who can give information and support that is tailored to individuals' needs and circumstances.

While it is still early days for the year-long pathfinder, awareness and usage of the service is growing at a strong rate, offering practical support to people to help them manage their finances better. The service has already helped thousands of people with diverse personal finance issues, such as:

- budgeting and making ends meet on a reduced income;
- using a redundancy payment to reduce debts;
- coping with the financial repercussions of the death of a spouse and understanding what benefits are available; and
- how to maximise income in retirement by finding a good deal on an annuity.

8.11 The Money Guidance service provides real help for people to gain control of their finances before they get into unmanageable debt and offers support to those facing sudden shocks such as job loss – this is all the more important in these tough times for consumers.

8.12 The Government is therefore taking steps to prepare for rollout of a national money guidance service from spring 2010, subject to the interim evaluation findings from the pathfinder indicating that the service can be effective. The Government will bring forward primary legislation to take a power to direct public funds to support delivery of Money Guidance. The Government has also already confirmed, at Budget 2009, that dormant accounts funds would be directed to support the implementation of the service.

8.13 The Government wants to ensure that all relevant financial services firms are required to contribute to the costs of Money Guidance, as the Thoresen Review recommended. FSA-regulated firms already pay towards supporting financial capability initiatives, including the Money Guidance pathfinder, as part of the FSA levy and will contribute to the funding of Money Guidance in a similar way in the future. However, some financial services firms do not come under the FSA levy as they are licensed solely by the OFT for consumer credit activities. The Government intends to take a power to bring relevant consumer credit firms into the funding

[4] *Thoresen Review of generic financial advice: final report*, Otto Thoresen, March 2008 (available from www.hm-treasury.gov.uk)

base for Money Guidance. The Government is committed to introducing a proportionate and efficient levy regime for those consumer credit firms affected and will consult further on the detail of the scheme.

8.14 It is also important the Money Guidance is able to support consumers to make sound choices when it comes to selecting and managing consumer credit products. The Government's consumer white paper, published on 2 July, set out plans to include a credit card comparison tool on the Moneymadeclear website and to take legislative steps to ensure that the Money Guidance service is not subject to certain provisions intended for the regulation of consumer credit firms.

8.15 Consultation questions related to these measures are set out in the Annex.

Strengthening the FSA's work on financial capability

8.16 The FSA has a statutory objective to promote public understanding of the financial system; it fulfils this through its consumer education activity and specifically through the FSA's National Strategy for Financial Capability, working in partnership with the Government, the third sector and industry.

8.17 Financial education initiatives and services such as Money Guidance are a much-needed source of help for consumers looking for support to manage their finances in the downturn and to prepare for the future. Therefore the Government believes that the FSA should do more to sharpen its focus on delivering consumer information and education and devote appropriate capacity and capability to oversee efficient delivery of consumer education initiatives, including national implementation of Money Guidance. It will do this in close collaboration with the specialist consumer education and guidance provided on pensions by the Pensions Advisory Service and other bodies.

8.18 To strengthen the FSA's consumer education capability, the Government intends to bring forward primary legislation requiring the FSA to establish an independent consumer education and information authority.

8.19 The legislation will:

- amend FSMA to require the FSA to establish the new authority, setting out the authority's specific functions and objectives in respect of consumer education and information provision;
- establish the authority's board and Chairman. It is intended that they should be appointed by the FSA, with the approval of the Treasury in the case of the Chairman, ensuring however that the terms of their appointment will secure their operational independence;
- confer powers on the authority to allow collection of revenues from FSA-regulated and OFT-licensed firms by way of levies and to allow it to receive a range of other funding streams, including public funds;
- give the authority the ability to delegate functions where other organisations might be better placed to deliver; and
- provide the authority with statutory immunity in relation to the discharge of its functions.

8.20 The new authority will take the strategic lead on consumer education and information provision relating to personal finance. It will work with regulatory bodies and consumer representatives, including the Consumer Advocate proposed in the recent consumer white paper, to ensure an effective, strategic approach to crosscutting issues affecting consumers.

8.21 Consultation questions on these measures are set out in the Annex.

Access to simple, transparent products

8.22 For many products, the sheer complexity and volume of 'small print' can act as a deterrent and can mean that, without regulated advice, people buy the wrong product or fail to engage with financial services at all.

8.23 The Government has twice introduced measures intended to improve access to basic financial products. In 1998 it introduced CAT (Charges, Access, Terms) standards and in 2005, following the Sandler report[5], these were replaced with 'stakeholder' products, a suite of simple products with defined characteristics.

8.24 Both stakeholder and CAT standards imposed requirements on charges, accessibility and terms. However, neither were popular with the financial services industry, which argued that charge caps made the products unprofitable and consumers did not demand them. This is backed up by sales data for products in markets with a high degree of choice – according to Association of British Insurers (ABI) data, less than a quarter of Individual Savings Accounts (ISA) sold in 2007 by ABI members were stakeholder ISAs. Similarly, stakeholder pensions have greatly improved the functioning of the personal pensions market, but have not by themselves resolved all the issues facing pensions.

8.25 It seems clear that while stakeholder and CAT standard initiatives were partially successful, there is further to go. The ideal system would allow freedom over product design, while guiding those people who would be best served by basic, cheap and accessible products in the right direction. Wherever people do choose other, more complex options, the system should make sure that they do so knowing about cheaper and simpler alternatives. The Government welcomes views on how best to achieve this, including for products which serve the most basic and widespread consumer needs – such as current or saving accounts.

8.26 There has been specific action to make consumers' decisions on private pensions more straight forward through the 2008 Pensions Act, which establishes a universally-accessible independently-provided occupational pension product alongside products provided by the financial services industry. This will be introduced in 2012.

8.27 One option which the Government believes could be worth further investigation is the "traffic-light" system which has been introduced into food labelling. While financial services and food are clearly very different classes of consumer products, there may be important lessons to be learned from food labelling for improving the transparency of financial products.

8.28 Whatever new system is implemented, a particularly important question will be whether it should be voluntary or compulsory. Compulsion would pose challenges, particularly in defining the affected products and ensuring compliance with relevant EU law. However, there is a risk that a voluntary scheme would not work – for products which would be rated as complex or expensive, there would be a strong incentive on providers not to provide a rating at all. The Government is therefore inclined to work towards a compulsory scheme.

8.29 These issues are set out in more detail in the Annex, including consultation questions. The Government intends to undertake further analysis on these issues on the back of this consultation, working with the FSA. It will issue a more detailed consultation on this subject by the end of the year.

[5] The Sandler Review of Medium and Long-term Retail Investment was set up by the Chancellor of the Exchequer in July 2001 and published in July 2002. One of its recommendations was for the Government to develop specifications for a suite of simple low cost, and risk-controlled "stakeholder" products that would help drive competition in the industry and improve access to financial services for those on lower incomes. See *Sandler Review: Medium and Long-Term Retail Savings in the UK*, Ron Sandler, July 2002 (available from www.hm-treasury.gov.uk)

Financial inclusion

8.30 Following agreement between the Government and the banking sector, reached in the wake of Policy Action Team 14's report on financial inclusion,[6] 17 banks now offer a basic bank account. Overall there are 7.7 million basic bank accounts in operation in the UK, with an average of 150,000 new basic accounts opened every quarter. Since 2003-04 the number of people without access to a bank account has reduced from 2.8 million to 1.9 million[7], making significant progress towards the Government and the banks' shared goal to halve the number of "unbanked" adults. The latest round of mystery shopping of basic bank accounts by the Banking Code Standards Board suggests there are now few obstacles to accessing basic bank accounts to those who want to open one.[8]

8.31 However, there is still further work to be done to ensure that everyone can access a transactional bank account. Currently the Banking Code obliges subscribers who offer a basic bank account to assess whether a customer's needs are suited to a basic bank account and, if so, to offer one. The Code also includes provisions on the availability of literature on a basic bank account, procedures for verifying identification documents and timescales for opening accounts. From 1 November 2009, the FSA's conduct of business rules for banking will require the communication of appropriate information to banking customers, including, where relevant, information on basic bank accounts. Supporting industry guidance, reflecting the Banking Code provisions, is expected to be agreed between the FSA, the British Bankers' Association (BBA) and the Building Societies Association (BSA). This should ensure that the new banking conduct of business regime maintains the existing requirements for established providers and new entrants and includes continuing checks on compliance.

8.32 The Government remains committed to ensuring a continuing reduction in the number of adults without access to a bank account, working in partnership with the banks. The Government awaits further analysis and recommendations into progress made towards the shared goal from the Financial Inclusion Taskforce and will set out next steps in the 2009 Pre-Budget Report.

Mortgages and consumer credit

8.33 For many people, taking on a mortgage is the most significant financial commitment they will make in their lifetime. The Government has taken action to ensure competitively priced mortgages continue to be available to a range of borrowers.

8.34 Getting on to the property ladder is an important step for many households. Despite falling house prices, many prospective homebuyers continue to experience difficulties accessing the housing market. The Government offers first-time buyers a range of support to help them realise their aspirations to become homeowners, as set out in Box 8.B.

8.35 The Government seeks to create a mortgage market that works well for a wide range of creditworthy borrowers. A robust and responsive regulatory system is a key element in ensuring a mortgage market that is both innovative and sustainable, offering products that suit the needs of a variety of borrowers while providing an appropriate level of consumer protection.

8.36 The following sections of the paper set out Government proposals and thinking on improvements to mortgage and credit regulation. Views are invited in response to the consultation questions set out in the Annex.

[6] *Access to financial services, report of PAT*, HM Treasury, November 1999 (available from www.hm-treasury.gov.uk)

[7] The latest figures are available from the Treasury website. See *Progress towards the shared goal on access to bank accounts*, HM Treasury, June 2009 (available from www.hm-treasury.gov.uk)

[8] *Mystery shopping review of the provision of information on basic bank accounts: summary results*, Banking Standards Board, March 2008 (available from www.bankingcode.org.uk)

Box 8.B: Help for first-time buyers

Help for first-time buyers includes a range of shared ownership and shared equity programmes, targeted tax measures and housing initiatives:

- the Government provides direct assistance to first-time buyers through the HomeBuy scheme. This scheme consists of two products – New Build HomeBuy and Social HomeBuy – which can help first-time buyers get on the property ladder through shared ownership arrangements;
- on 2 September 2008, the Government launched a new shared equity scheme, HomeBuy Direct, helping eligible first-time buyers to buy their own homes by offering an equity loan of up to thirty per cent of the value, co-funded by the Government and a participating developer providing the homes, and free of charge for five years;
- as part of the 2 September package, the Government announced a stamp duty land tax (SDLT) holiday for all houses costing up to £175, 000. The holiday was introduced to demonstrate Government support for homebuyers, including first time buyers, at a time of difficult conditions. During the period of the holiday around 75 per cent of residential purchases by first time buyers will be exempt from stamp duty. In recognition of continuing difficulties in the housing market, Budget 2009 announced an extension of the SDLT holiday to December 2009; and
- As part of Building Britain's Future, the Government has provided £1.5bn over the next two years to enable more families to access the housing they need, including assisting a further 6,750 households into homeownership.

Mortgage regulation

8.37 Since 2004, the FSA has held responsibility for the regulation of first-charge residential mortgages. The FSA's regime provides consumers with important protections regarding their mortgages, including requirements that lenders treat customers fairly and treat repossession as a last resort. The regulatory regime also provides means of redress for consumers who experience problems, through access to the Financial Ombudsman Service (FOS).

8.38 The current economic conditions present new challenges and the Government is committed to ensuring that the regulatory system is robust and up to date. One such emerging trend, which could reduce protection for borrowers, is lenders in distress selling their mortgage books on to unregulated firms. The Government will consult later this year on the best way to protect consumers when lenders sell on mortgage books, with a view to bringing forward legislative measures if necessary.

8.39 The Government is also committed to ensuring that repossession is always a last resort, and that all borrowers have comprehensive protection through FSA regulation and the courts.

8.40 The disruption of financial markets also raises issues about the way that financial markets interconnect and the role of regulation. The crisis was triggered by problems in the United States sub-prime market. Concerns about this market spilled over into financial markets across the world with unexpected speed and force. Prudential regulation helps to protect the financial system against losses, and therefore minimises disruption across financial markets. Firms that are not FSA-regulated, however, are not subject to prudential controls. There is a case for

considering whether the current regulatory framework takes full account of wider market risk, particularly as below in respect of second-charge and buy-to-let markets.

Consumer credit

8.41 Apart from first-charge mortgages, all consumer credit business, including second-charge mortgages, is regulated by the Office of Fair Trading (OFT) under consumer credit legislation. The Government does not intend to make fundamental changes to the institutional framework for the regulation of consumer credit at this time, while changes are being implemented as a result of European legislation. The Government remains open to looking at the case for a single regulator for credit in the medium term, while recognising that there are wider consumer protection implications of any shift that would need to be balanced.

8.42 On 2 July, the Government published a white paper on consumer rights. This set out proposals to provide further help to people in difficulty with their finances and proposals to strengthen the UK's credit regime, including measures to:

- tackle consumer protection issues in particular parts of the consumer credit market;
- raise standards in decision-making across all regulated consumer credit products; and
- make the regulatory regime for consumer credit effective for all consumers.

Second-charge lending

8.43 In March this year, the Government announced that it would review the current split of OFT and FSA regulation in relation to second-charge mortgage lending. The Government will review the case for transferring regulation of second-charge mortgages to the FSA, and will update by the 2009 Pre-Budget Report.

Buy-to-let lending

8.44 The buy-to-let mortgage market has grown very rapidly over the last decade, and plays an important role in providing funding to the private rented sector, although recent falls in house prices may have made the market less attractive for investors. When the Government introduced mortgage regulation in 2004, it drew a distinction between owner-occupiers who face losing their home if things go wrong, and buy-to-let landlords, whose properties are investments and who do not face the same risks.

8.45 In light of the growth of the market, and taking into account recent events that have shown how problems in mortgage markets can spill over into financial markets more generally, there is a case for considering whether the Government should give the FSA the powers to apply conduct of business and prudential regulation to all buy-to-let lending. The Government will review the case for FSA regulation of the buy-to-let market and will update by the 2009 Pre-Budget Report.

Strengthening FSA rules on mortgages

8.46 On 22 February, the Prime Minister announced that the Government had asked the FSA to consider controls on mortgages of more than 100 per cent of a home's value. In the Turner Review, the FSA announced its intention to publish a paper in September of this year on mortgage market reform. In this, the FSA will consider:

- the complete value-chain in the market (including lenders, investors, intermediaries and consumers);

- all aspects of regulation, including prudential, conduct of business, and financial crime;
- moving from general standards of lender behaviour to prescriptive product regulation, including maximum loan-to-value and loan-to-income caps; and
- the appropriateness of a read-across to the mortgage market of the proposals made by the Retail Distribution Review of the investment market.

8.47 The Government will take the findings of the FSA's work into account in its forward work on regulation.

Mortgage insurance

8.48 Lenders can manage the risks associated with lending at high loan-to-values (LTVs) in a number of ways. These include taking out mortgage insurance. In the UK, there is a market for mortgage insurance provided by the private sector.

8.49 Some countries have adopted alternative models for mortgage insurance provision, such as Canada, where mortgage insurance is compulsory for all mortgages above a lower limit and below a maximum proportion of a home's value. It is sometimes argued that this model helps provide borrowers with continued access to mortgage finance, by encouraging risk sharing between insurers and lenders, and helping ensure that lenders do not take excessive risks when the economy is growing and do not withdraw from higher LTV lending during periods of economic disruption.

8.50 Some UK stakeholders have proposed that the Government considers the benefits of international models like Canada. The Government is interested in the lessons that may be learnt from the experiences of other countries and will update at the Pre-Budget Report.

Consumer protection

8.51 While it is clear that every effort must be made to help consumers get the products that are right for their needs and circumstances, it is also important to ensure there are sensible processes for dealing with problems that emerge and for providing redress and compensation when things go wrong. The following sections therefore consider improvements to these areas.

Swift and effective consumer redress

8.52 The way that firms deal with customer complaints is a key determinant of consumer confidence. Failure to resolve a problem can have a disproportionate impact in direct costs, loss of business and goodwill to the industry as a whole. By contrast, effective complaints-handling delivers fair and speedy outcomes, and reduces the need for regulatory action. It engenders trust in an industry that depends on trust; and it helps to rectify, after the event, some of the information asymmetries faced by customers before entering into a transaction.

8.53 The number of complaints referred to the FOS has risen year on year since it was established in 2001. 31,347 complaints were referred for decision in the first year, compared to 127,471 in the year to March 2009, a fourfold increase[9]. The FOS and the FSA expect the volume of complaints to rise during the current economic downturn, as firms struggle to contain costs and boost capital with potentially negative impacts on consumers. FOS expects its caseload to rise to 150,000 in 2009-10[10].

[9] See the Financial Ombudsman Service annual reports (available from www.financial-ombudsman.org.uk)
[10] *Corporate plan & budget for 2009/10*, Financial Ombudsman Service, March 2009 (available from www.financial-ombudsman.org.uk)

8.54 The distribution of complaints is uneven. Mortgage endowment policies provided 63 per cent of cases in 2004-5, 61 per cent in 2005-6 and 49 per cent in 2006-7. Current accounts and credit cards provided 43 per cent of cases in 2007-8. In the current financial year, Product Protection Insurance (PPI) and credit cards provided 38 per cent of cases, and 52 per cent of cases came from just six financial groups. This suggests that a relatively small number of products and firms, affecting large numbers of customers, are responsible for driving down confidence in the financial services industry, although they may not be the same products and firms every year.

8.55 Complaints dealt with by FOS may be an indicator of a much larger volume of complaints settled by firms themselves, and of the number of customers who do not come forward because they are unaware of their rights or because their claims are small. According to one study by the OFT, around half of consumers with a complaint do not pursue it[11].

8.56 The Government believes that more can be done to drive up the standards of complaints-handling by firms, reduce the number of cases referred to the FOS, and use complaint systems to identify and close down emerging issues before they become widespread.

8.57 The Government recognises that complaints may need to be suspended while the law or regulatory rules are clarified, but it proposes to examine how action might be taken that does not put consumer complaints on hold for long periods. It proposes a package of measures, set out below, to:

- reform the "wider implications" process, through which cases that may affect a large number of consumers in a similar way are addressed; and
- support collective action through which consumers can enforce their rights to redress through the courts.

The "wider implications" process

8.58 This section looks at the redress mechanisms for cases that similarly affect large numbers of customers. The so-called "wider implications" process addresses emerging issues that may affect:

- a large number of consumers or firms;
- the financial integrity of a large business;
- the interpretation of FSA rules or FSA and OFT guidance; or
- a common industry practice.

8.59 The wider implications process is not a formal procedure. It is open to the regulator, firm, trade body or consumer group to raise a particular issue. Depending on the issue, the FOS will confer with the FSA or OFT (or both) and they will decide jointly whether it has wider implications; and whether the process should apply. In some instances, the issue may be discussed with industry or consumer groups. The process has been invoked in 13 cases[12] since 2002, ranging from credit card pricing to long-term care insurance. The latest example was in May 2009, where the process was invoked to deal with financial advice provided on structured products, in the light of complaints received in relation to structured products backed by Lehman Brothers.

11 *Consumer detriment: assessing the frequency and impact of consumer problems with goods and services*, Office of Fair Trading, April 2008 (available from www.oft.gov.uk)

12 The 'wider implications' case studies carried out by the Financial Ombudsman are summarised on the wider implications website, www.widerimplications.info

8.60 The Government believes that there is scope to improve the wider implications process, so that it can be used more extensively to identify and address the root causes of problems before there are widespread complaints, avoiding the need for regulatory enforcement action where possible. It should be possible to do this more openly, with fewer confidentiality issues, if action is taken early. In a more collaborative process, it would be possible to make better use of complaints data, do more to invite referrals, encourage whistleblowing, or get firms or consumers to come forward at an earlier stage and close down potential problems before they become widespread. The Government does not believe that decisions should be referred to another body. Regulatory decisions taken as a result of the wider implications process are capable of judicial review in the normal way, and any rule changes are subject to consultation requirements.

8.61 Other future steps on this include:

- the FOS has announced that it will publish firm-specific data on the volume of complaints it has dealt with, and their outcomes, beginning in the autumn;
- the FSA will shortly be consulting on a proposal to require firms to publish their own complaints data; and
- the FSA is undertaking an internal review, with OFT and FOS, of the wider implications process. The Government has asked it to consider, as part of its review, how the process could be restructured to be more proactive, transparent, consultative and streamlined. The Government has invited the Retail Financial Services Forum to examine how the wider implications process might be restructured and to report by 30 October 2009.

Collective action

8.62 There have been several instances in recent years in which a large group of consumers has suffered detriment at the hands of regulated firms. They include, for example, the mis-selling of endowment policies, personal pensions, split capital investment trusts, precipice bonds and payment protection insurance.

8.63 Despite the history of widespread consumer detriment arising from particular products or practices, there has been relatively limited use of existing procedures for collective redress purposes:

- a representative body that does not itself have a cause of action may not bring a court action on behalf of other parties, except in cases before the Competition Appeals Tribunal;
- potential complainants may be put off using existing court procedures by a fear that the process may be too lengthy and expensive. They may also be deterred if their claim is small, or by the "loser pays" principle;
- the FSA’s powers to secure restitution, as it did over the splits case, have not been much used. The regulator must balance consumer protection with other factors. Its resources are limited and it must take its own costs into account. This may lead it to conclude that consumers should seek redress through the FOS or private proceedings;
- the FOS is not primarily a vehicle for collective redress because it is designed to deal with complaints by deciding what is fair and reasonable in all the circumstances of each individual case. It cannot decide a case in the absence of a complaint, although many people may have been affected by the alleged conduct. Its decisions are not binding on an individual consumer or group of consumers;

- the procedures may be underused or insufficiently understood and many consumers may not realise that they have the basis for a complaint; and
- where there is a novel or difficult legal issue, complaints may be individually contested.

8.64 The Civil Justice Council (CJC) has expressed the view that court procedures have been unable to keep pace with the frequency with which generic claims may arise[6]. For a case to be managed by way of a group litigation order, or for a test case to be selected, there must first be a number of cases before the courts. The complainants must therefore be actively involved in the proceedings and be subject to court rules on disclosure and costs, which could in turn create a disincentive to claimants. Further, a test case does not finally determine all the individual actions, although it can determine issues of principle. Moreover, a number of proceedings taking place in different county courts could lead to unpredictable and inconsistent judgments and a consequent need to stay proceedings if there is the possibility of a test case.

8.65 The CJC considers that representative actions under the Civil Procedure Rules may offer an efficient and productive procedure for collective action. But the procedure is not often used.[7] This appears to be because of difficulties or uncertainty associated with certain legal tests that must be satisfied, including that there is sufficient commonality of interest among the cases.

8.66 The Government is considering its response to the recommendations on representative actions made by the CJC. It intends to publish its response on the way forward before the summer recess. The European Commission has also been considering the question of mass claims. It published a consultation paper setting out policy options ranging from voluntary self-regulation to an EU-wide collective redress mechanism including alternative dispute resolution[13].

8.67 The Government believes that the emphasis should remain on ensuring that firms compensate the consumer voluntarily. When that is not possible, and many consumers are affected in a similar way, there should be routes to collective redress that can deal with claims more efficiently, reduce the time that claimants may have to wait, and reduce the volume of individual cases dealt with by the courts or FOS. This is the approach taken in the recent consumer white paper to allow a Consumer Advocate to take a collective action on behalf of consumers following a breach of consumer protection law where firms have failed to compensate voluntarily.

8.68 The Government therefore invites views on the case for legislating to:

- update regulators' existing backstop powers to deliver collective redress;
- introduce some form of collective action through which consumers can enforce their rights to redress.

8.69 These legislative options and related consultation questions are detailed in the Annex.

[6] See *Improving justice through collective actions,* Civil Justice Council, November 2008 (available from www.civiljusticecouncil.gov.uk)

[7] *Improving justice through collective actions,* p.34

[13] *Consultation paper for discussion on the follow up to the green paper on consumer collective redress*, European Commission, May 2009 (available from http://ec.europa.eu)

Box 8.C: The OFT's test case on bank charges

More than one million complaints about bank overdraft charges are outstanding.

The OFT and the banks agreed to a test case in July 2007 in order to resolve issues concerning the general application and interpretation of the Unfair Terms in Consumer Contracts Regulations 1999. The OFT will be able to challenge the future use of bank charges that is considers to be unfair if the outcome is in its favour.

The case is in two stages. Stage one considers whether unauthorised overdraft charging terms can be assessed for fairness under the Regulations. This stage has now reached the House of Lords. Depending on the outcome, stage two will establish whether the terms are unfair. Once the application of the Regulations is clarified, customers will be able to pursue their complaints against the banks if they consider that the outcome is in their favour.

One way to determine the fairness of the bank charges in the OFT's test case is for litigation to continue until it reaches a conclusion. However, this may take some years. Subject to the outcome of the stage one proceedings, the Government therefore calls on the regulators and the banks to explore whether there is a quicker way of resolving these cases that is preferable for customers to pursuing further litigation, and provides the certainty that regulators and banks need. The Government will also work with interested parties with a view to moving the market to a more efficient, equitable, and transparent system as quickly as possible.

Depositor protection and compensation

8.70 Effective and credible compensation arrangements always have an important role to play in any system for protecting depositors (or other types of customers of financial services firms) and in maintaining a high level of confidence in the financial system as a whole.

8.71 Improvements to the operation and financing of the UK's Financial Services Compensation Scheme (FSCS) have therefore been central to improving consumer protection in financial services. In the last two years, the Government and the FSA have taken a number of measures in this area including:

- strengthening FSCS funding arrangements;
- increases in deposit compensation limits;
- allowing (on a temporary basis) separate compensation coverage when building societies merge or when accounts are transferred in a resolution under the Banking Act;
- technical improvements to the legal framework for the FSCS to allow for faster compensation pay out.

8.72 The Government and the FSA continue to take further measures to strengthen compensation arrangements. Most changes to the FSCS can be made by the FSA in changes to its rules and the FSA is considering a wide range of detailed technical measures which will improve the provision of effective compensation to consumers by the FSCS, including:

- moving to gross rather than net FSCS pay out;

- the introduction of a mandatory "single customer view" to ensure that institutions could provide a reliable and consistent picture of a customer's aggregate position with an institution;
- simpler eligibility criteria for claimants;
- improved communication about compensation arrangements with bank customers; and
- measures to provide protection for balances temporarily above the deposit compensation limit.

These are in addition to the work on the governance of the FSCS set out in Chapter 4.

Deposit protection across the EU

8.73 But further improvements are needed at a more strategic level. In particular, as well as strengthening UK arrangements, the Government believes more can be done to strengthen protection of depositors with cross-border banks in the EU and ensure that measures to strengthen national compensation arrangements do not undermine the development of the Single Market in banking and financial services.

8.74 The European Commission has suggested that "further consideration as well as a cost benefit analysis on the setting up of a pan-EU deposit-guarantee scheme will also be undertaken in the context of the Commission's report at the end of 2009".

8.75 A significant amount of work is required to deliver modern and effective deposit guarantee arrangements for cross-border institutions. A number of important issues will need to be addressed including, but not limited to, ensuring that national schemes are equipped to support resolution actions to minimise losses before an institution fails; are adequately funded or have access to national funds; and enjoy stronger coordination and peer review between national schemes so that depositors can have confidence in cross-border deposit guarantees, with a single point of contact in their home country, described more fully below. In addition depositors must be confident that they will be compensated quickly after a failure.

8.76 The Government will write shortly to the European Commission setting out its views on the key issues surrounding options to strengthen deposit-guarantee arrangements in the EU.

Single point of contact

8.77 Under EC law, credit institutions in one Member State may open branches in other Member States under a "passport" issued by their home regulatory authority. Deposits with those branches are then protected by the deposit guarantee scheme of the home country rather than the scheme in the country where the branch is established (the host). In addition, the protection provided by the home scheme may be 'topped-up' by the host deposit guarantee scheme in certain circumstances. But this means that, strictly speaking, if the credit institution fails, depositors with the host State branches must apply for compensation to the scheme in another country – the credit institution's home – and may even have to apply to both schemes if topping-up applies.

8.78 The Government believes, therefore, that the EU should move towards a system in which host schemes would always act as the single point of contact for depositors in their country, irrespective of which scheme had the ultimate liability to pay for the compensation given to depositors. This would probably require some greater degree of harmonisation between deposit-guarantee schemes and the host state would require adequate information regarding eligible depositors. It is nonetheless compatible with a range of potential arrangements varying from a

simple contact point, through acting as claims agents, to processing claims and paying compensation on behalf of the home scheme.

8.79 The Government invites responses to its consultation question on these areas, as set out in the Annex.

9 Competition and choice in financial markets

Competition and choice are vital for improving the efficiency and responsiveness of financial markets for their users. The Government remains committed to maintaining such competitive markets in the UK.

The characteristics of financial markets - especially banking - create particular complications for competition. This is partly as a result of the importance of factors such as trust and confidence, and also because of the role of networks such as payment systems and branches. These issues have been highlighted in various studies and investigations by the Office of Fair Trading and the Competition Commission over recent years, which have identified significant barriers to entry in the UK. These and other evidence bases are important for understanding and tackling the challenges facing the Government in its desire to increase competition and new entrants.

The recent crisis has affected banking for retail and small business customers. There have been a range of developments, including mergers and exits from some markets, which have increased concentration. State assistance across the world has allowed some firms to continue to do business when they, and potentially the system as a whole, might otherwise have failed.

The Government proposes four important sets of actions to reinvigorate competition in the banking sector:

- given the importance of regulation in creating barriers to entry, it is essential to ensure that market access is firmly embedded into decisions about financial rule-making, including through the work of the OFT, the FSA and the EU, and that these and other institutions work together closely;
- supporting competition and choice through diversity, most importantly through maintaining a strong mutually-owned financial sector, by:
  - ensuring that its regulatory and legislative framework is modernised;
  - supporting better governance; and
  - considering the sectors needs for capital and funding;
- Government action where markets cannot provide solutions, such as supporting innovation – through the Innovation Fund – and social investment; and
- ensuring an orderly exit from the various interventions, in the UK and internationally, making clear that the Government intends to sell the equity stakes that it has invested in UK banks.

Government's commitment to a competitive market

9.1 The Government believes that competition is vital in ensuring efficiency in financial markets and in protecting the consumer's interests. Choice can be an important element of competition and is a vital aspect of decision-making by users of services. The Government:

- is committed to encouraging new entrants into financial services in the UK;
- will seek to strengthen the ability of mutual societies to compete in future; and
- recognises the need to intervene to help in areas where markets cannot provide solutions, such as in its ambition to create a Social Investment Wholesale Bank.

9.2 The Government's framework for competition policy is strong. The Office of Fair Trading (OFT) is the UK's competition and consumer authority, with a mission to make markets work well for consumers. The Competition Commission is an independent public body with responsibility for competition in mergers, markets, and the major regulated industries. Between these two bodies, the competition framework ensures that UK consumers of financial services are well served by competitive financial markets, and well protected should competition in those markets break down.

9.3 This chapter looks at the nature of competition and choice in UK financial markets, especially in banking for retail consumers and small firms, and considers the effects to date of the financial crisis on those markets. It then discusses the factors relevant to increasing competition, describes actions already under way, and sets out new proposals by the Government to promote competition, including reforming regulatory arrangements. It also describes the Government's plans to exit from its current short-term interventions in financial markets.

Competition and choice in the UK retail financial market

9.4 Competition in banking is inherently complex, given the importance of trust and reputation, as well as the significance of networks like branches and payments systems.

9.5 As identified by the OFT and the Competition Commission in previous market studies, some of the drivers of competition in banking in the UK differ from those in product markets. In particular, banking sector competition is in large part driven by consumer behaviour and by business practices of banks rather than simply by market concentration. The market place is characterised by low switching activity and a lack of customer awareness about banking costs and difficulty in comparing offers from different providers. This makes it more difficult for new entrants to establish and expand their businesses.[1] In turn this enables banks to segment the market by targeting particular brands and products at price sensitive consumers.

9.6 The UK banking market, like banking markets generally, has also been characterised by high barriers to entry. Analysis by the OFT and the Competition Commission highlights six barriers that can prevent entry to the UK retail banking market:

- **the need to establish a branch network** – it is expensive to establish and maintain a branch network, but historically seen as vital for the raising of deposits. 92% of customers use in-branch services at least once a year[2];

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[1] For example: *Anticipated acquisition by Lloyds TSB plc of HBOS plc: Report to the Secretary of State for Business Enterprise and Regulatory Reform*, Office of Fair Trading, October 2008; *Personal current accounts in the UK*, Office of Fair Trading, July 2008; *Review of the undertakings given by banks following the 2002 Competition Commission report*, Office of Fair Trading, August 2007 (all available from www.oft.gov.uk); *Notice of provisional decision to release Undertakings in relation to SME banking given pursuant to section 88 of the Fair Trading Act 1973*, Competition Commission, August 2007 (available from www.competition-commission.org.uk) and *Sector Inquiry under Article 17 of Regulation (EC) No 1/2003 on retail banking (Final Report)*, European Commission, January 2007 (available from www.ec.europa.eu)

[2] See *Personal current accounts in the UK*

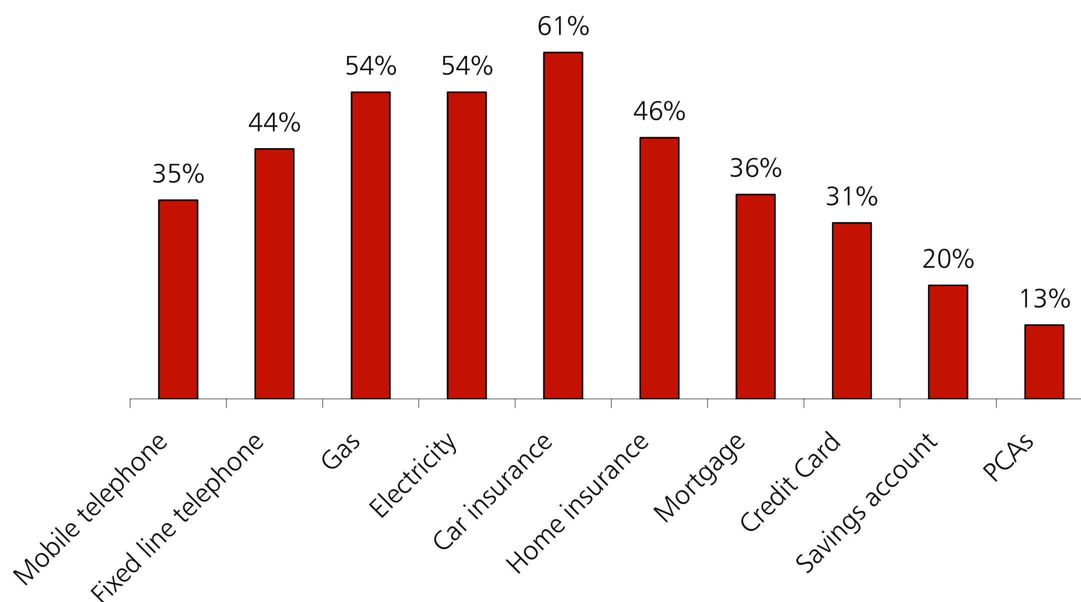
- **a successful brand** – a Competition Commission enquiry into PCAs in Northern Ireland found that brand familiarity was crucial to success in the market and there was strong loyalty toward existing players[3];
- **a low customer churn rate** - the OFT has identified the low customer switching rate in the UK to be a significant inhibitor of competition. Possible future steps to address this are dealt with below;
- **access to payments networks** – a range of complex systems is required for banks to offer retail banking services to customers;
- **regulatory requirements** – for example the FSA sets out higher capital ratio requirements for new entrants than for existing banks; and
- **access to customers' credit risk information** – The OFT has found that this barrier is not a particularly complex or expensive process[4].

9.7 The following section provides further thoughts on three of the issues – customer churn, technological possibilities and enabling other business models to enter the market. Related consultation questions are contained in Annex B.

Measures to support consumer switching to drive competition

9.8 The number of customers willing to switch accounts is a measure of both competition, through creating pressure on incumbent banks, and the openness of a market to new entrants, as customers that switch products are the most likely source of custom for a new operator.

Chart 9.A: Customer switching across different sectors in 2008 - the proportion of people who have switched provider in the last 5 years



Source: Personal Current Accounts in the UK, OFT, 2008

[3] *Personal current account banking services in Northern Ireland: market investigation*, Competition Commission, May 2007 (available from www.competition-commission.org.uk)

[4] See *Personal Current Accounts in the UK*

Supply-led

9.9 Both the reality and the perception of the difficulty of switching bank accounts increase customer inertia. 28 per cent of those who have switched bank accounts experienced difficulties with the process, 33 per cent would not recommend switching to friends and the perception of the difficulties involved deter 45 per cent[5] of those who have never switched. It can be argued that banks could take further steps to improve the experience of consumers and the OFT is already in discussions with industry stakeholders to make the switching process easier. The FSA may also have a role to play as it will be given a greater role in this area from November 2009, when it assumes control of retail banking business conduct from the Banking Codes Standards Board.

9.10 The concept of 'portability' may make it easier for consumers to switch. Just as International Bank Account Numbers have eased international payments by creating a universal coding system for account numbers, it may also be possible to create a bank account number that is specific to the individual rather than the bank. This would allow customers to take, for example, their bank account numbers and their corresponding direct debit schedules to different providers, as customers already can with mobile telephone numbers. However, this would have important systems requirements.

9.11 There is also potential to increase the transparency of financial products and provide clear price signals for consumers. The OFT is engaged in discussions with the industry on increasing the transparency of tariff structures through measures such as more informative statements and providing charging structure scenarios to aid comparison. Interventions such as those being discussed by the OFT, or a traffic light system or a compulsory annual summary of charges and interest, as recommended by the Competition Commission market enquiry into Northern Ireland banking services[6], could give consumers easy-to-understand tools to help them navigate complex financial decisions, encourage switching where appropriate and empower customers as agents of change in the retail banking system.

Demand-led

9.12 Empowering consumers to make proactive, informed financial choices and, through measures to improve consumers' capability, supporting them to shop around for a good deal and switch is crucial. The Government and the FSA announced in July 2008 a joint programme of action to help raise the low levels of financial capability in the UK, as detailed in chapter 8.

The impact of new technology on encouraging new entrants

9.13 Technology has provided new and innovative ways of banking and is likely to continue to do so in the future. It may help to overcome the need to establish a branch network. New entrants may be able to compete more easily with incumbent firms in the market owing to the reduced operating costs. For example, the OECD estimates that by transferring bank account transactions to electronic banking the cost per transaction is reduced by 90 per cent[7]. New technology may offer access to new markets through providing new mediums to interact with customers. For example, the ability to access bank accounts via mobile telephones may offer new possibilities for the financially excluded. Two specific areas of development are set out below.

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[5] Source: Office of Fair Trading

[6] *Press release: final CC decisions on actions required by the banks*, Competition Commission, May 2007 (available from www.competition-commission.org.uk)

[7] *Internet Banking in Estonia*, Katri Kerem, PRAXIS Center for Policy Studies, 2003

Mobile phone technology

9.14 The interaction between mobile telephone technology and banking has so far led to two main areas of innovation: payments systems and new forms of banking. However there are also minor, wider effects such as the opportunity offered to customers to track their finances more closely through the use of text message alerts.

9.15 The development of contactless mobile phone payments is at a very early stage of evolution. Currently, contactless mobile phone payments are limited to a maximum of £10 and operate by means of a credit/debit card function being integrated into the phone that requires user verification to process a payment. However, over time it is expected that this will be expanded to replicate a number of different card payment products.

9.16 The introduction of contactless payments is expected to bring a number of benefits such as: speed and convenience at the point of sale; reduction in cash usage and cost of cash; greater choice for customers in making payments; and, a greater level of consumer protection compared to cash. O^2 in connection with TfL, Barclaycard, and Nokia ran trials using mobile phones with a built in credit card and Oyster Card that uses near field communications technology[8] to access the London tube network.

9.17 Internationally, mobile phones have also created new forms of banking where the phone becomes the main focal point of a customer interaction. The M-PESA system in Kenya allows users to transfer cash via text message and is available to customers without a traditional bank account[9]. Whilst such a scheme is most relevant in developing countries without a developed banking infrastructure, there may be potential for similar systems in the UK. This could offer opportunities for new entrants and could increase financial inclusion.

New services available through the internet

9.18 The internet has led to new and innovative ways for people to interact. The rollout of high speed broadband over the next few years should look to foster this further. As well as allowing the introduction of direct banking, the internet also offers scope to access other kinds of financial services and products. For example:

- ancillary systems: online payments – systems like Paypal allow payments and money transfers to be made quickly and securely over the Internet[10], removing the need for checks and standing orders or for consumers to repeatedly type in personal account information to different websites. In 2007 Paypal had 164 million users worldwide[11]; and
- innovative products: peer-to-peer networks – for example, Zopa provides an internet service that connects potentials creditors to potential debtors and provides a credit checking service and a facility allowing users to select their preferred interest rate. Zopa has also explored the possibility of using rent payment history as a credit rating tool in collaboration with Notting Hill Housing.

[8] *Mobile handset to substitute Oyster cards*, David Meyer, ZDNet, November 2007 (available from www.cnet.co.uk)

[9] See www.safaricom.co.ke

[10] Paypal had a low fraud rate of 0.29 per cent compared to 1.5 per cent for credit card usage online in 2006. Source: World retail banking report 2008, Capgemini, EFMA and ING, December 2008 (available from www.www.capgemini.com)

[11] See World Retail Banking Report

Box 9.A: Developments in smart cards

Smart cards have been available since the 1990s and the technology has continued to develop. Smart card systems are used extensively in both Singapore and Hong Kong.

Developments in the UK have seen a sQuid card scheme launched in Bolton, Dundee, and Thames Ditton in Surrey. In Bolton sQuid cards can be used as library cards, for using leisure facilities, travel on the Greater Manchester Passenger Transport Executive (GMPTE) network, and for high-street purchases under £10[12].

Smart cards may offer new avenues for both encouraging new entrants into the market and increasing financial inclusion.

Impact of the financial crisis on competition in UK banking

9.19 The UK financial services market, like markets across the world, has been affected by the global financial crisis. These changes have altered market dynamics with implications for retail and small business consumers, primarily of banking services. These changes in market dynamic have been characterised by:

- widespread consolidation, affecting all parts of the banking market. Most notable have been the Lloyds TSB-HBOS merger and the growth of Santander following its purchase of Alliance & Leicester and Bradford & Bingley's deposits;
- the consolidation of a number of building societies, especially by Nationwide, and the development of a new, larger mutual rival, in the shape of Cooperative-Britannia; and
- exit from markets by many players, including for example the buy-to-let mortgage market and a particular tendency for foreign banks to scale back activities abroad, including in the UK, to concentrate on core home markets. The UK has for example seen a number of Irish financial institutions withdraw from the SME market.

9.20 While in normal circumstances a concentration in supply could be expected to feed directly into a diminution in competition, the other factors at play, and in particular consumer inertia, mean that the position is slightly more complicated. While there has undoubtedly been some decline in competitive pressure as a consequence of the consolidation driven by the financial crisis it is certainly not clear that there are now insufficient suppliers to provide effective competition in the UK banking market. At the same time other aspects of the crisis and the policy response to it have also have competition impacts. For example:

- the drying up of the wholesale funding markets has led to an increased emphasis on more “vanilla” funding models and there has consequently been an intensification of competition for retail deposits as a source of funding; and
- there is also some evidence that in the deposit market at least inertia has been reduced by savers are choosing to "spread" their savings across more institutions to ensure that their deposits fall fully within the scope of the £70,000 ceiling under the financial services compensation scheme.

9.21 The introduction of various forms of state assistance to the banking sector across the world, including in the UK, has also had competition impacts. While in most cases the various

[12] See www.squidcard.com

forms of assistance have had sector wide benefits either because support for individual institutions has also had wider stability benefits for the financial sector as a whole, or because the interventions are open to all institutions who wish to apply for assistance, at times it has also been necessary to apply conditions to particular interventions to avoid competitive distortions. For example Northern Rock has a self imposed a 1.5 per cent market cap on deposits and a 2.5 per cent cap on new mortgage origination, to ensure that it does not unfairly benefit from the Government support it has received.

9.22 The interaction between these various factors means that impacts on levels of competition in the UK banking sector has been complex and there has not been a simplistic link between greater consolidation and a reduction in competition. The following sections present the personal current account (PCA), mortgage and SME markets as examples.

Personal current accounts

9.23 The personal current account (PCA) is at the heart of UK retail banking. Not only is it indispensable to the functioning of the economy, but it also acts as an important gateway product that draws consumers into contact with a bank and other financial services. There were an estimated 64 million accounts in the UK in 2008, of which 54 million are estimated to be active.[13] At October 2008, the closing balances for UK PCA accounts stood at just over £100 billion[14].

9.24 The PCA market is characterised by:

- consumers not actively shopping around before choosing a current account supplier (60 per cent of new current account holders consider no other option than the one they ultimately select and less than 5 per cent compared the products of more than four potential suppliers[15]); and
- once an account has been chosen the consumer will typically hold it for a long period of time. Amongst customers the propensity to switch remains focussed on a subset of the overall market (nearly two-thirds of people have held their current account for more than 10 years and 60 per cent of people are still using the first current account that they ever opened[16]).

9.25 This is driven by the information asymmetries common to all financial services markets and Chapter 8 sets out steps the Government is taking to build consumer capacity to equip them to make more informed choices. However, in the PCA market, consumer inertia is also driven by:

- lack of transparent pricing: a combination of intricacy and a lack of transparency causes consumers to focus on the more evident bank fees instead of on less visible costs which may for some consumers be more substantial. In addition, the split between customers more inclined to switch and those who are likely to stick with one provider means that banks have some ability to segment the market and price accordingly, so that customers who are unlikely to switch do not benefit from the lower prices that switchers might achieve;

[13] See *Personal current accounts in the UK*

[13] See *Northern Rock: the impact of public policy support on competition*, Office of Fair Trading, July 2008 (available from www.oft.gov.uk)

[14] See *Northern Rock: the impact of public policy support on competition*

[15] See *Competition in UK Banking: A Report to the Chancellor of the Exchequer*, Ron Cruickshank, March 2000 (available from www.hm-treasury.gov.uk)

[16] See *Competition in UK Banking: A Report to the Chancellor of the Exchequer*

- **low financial capability**: as discussed above many consumers lack the understanding, confidence and motivation to ensure that they hold the most appropriate and competitive financial products for them; and
- **fear of switching**: the effort and inconvenience associated with changing bank accounts is a further factor that encourages customer stickiness.

9.26 While the financial crisis has led to a contraction in the number of PCAs in the UK, most commentators attribute this to consumers with more than one account streamlining their accounts rather than consumers moving to a substitute product. Despite the contraction in 2007-2008, recent and forecasted growth rates have been relatively consistent[17] and the market is still diverse with a number of different providers. Indeed, the premium that crisis conditions have placed upon deposit rather than wholesale market finance for financial institutions may have given financial institutions the incentive to compete more fiercely for PCAs.

Mortgages

9.27 Prior to the crisis the UK market was extremely competitive with the entry into the market of challenger banks (e.g. Northern Rock) and non-bank operators that used the securitisation markets to raise finance. These non-traditional lenders not only targeted price sensitive customers but also sought to expand the market by targeting the sub prime and buy-to-let sectors.

9.28 The drying up of the securitisation markets has led to some of these challenger and non-bank entrants withdrawing from the market. However, the impact of their withdrawal has been felt primarily in the non-core sectors such as sub-prime and buy-to-let. While this may have caused some firms and products to exit the market, in the main this reflects financial institutions returning to traditional lending patterns.

9.29 The financial crisis has also not affected the key characteristics of competition in the mortgages market, that is, a highly contestable market with low barriers to entry and to switching providers. Core UK mortgage markets remain open and competitive for consumers with good credit histories. This position has been reinforced by the lending commitments that the Government has agreed with RBS and Lloyds as a condition of Government support. RBS and Lloyds will provide an additional £12billion of mortgage finance on commercial terms and subject to demand over the 12 months from March 2009 (£9 billion from RBS and £3 billion from Lloyds.

Small and medium size enterprise (SME) banking

9.30 As in the PCA market, competition in the SME market is largely a function of behaviour and business practices, rather than solely market structure. The SME market tends to exhibit the same customer inertia associated with PCA banking, for largely the same reasons. However, the additional emphasis placed on personal relationships in SME banking means that a reluctance on the part of consumers to switch is if anything even greater.

9.31 In 2007, the OFT and the Competition Commission concluded that while competition constrained the pricing behaviour of the four main banks and limited their ability to charge excessive prices, improvements could still be made in the functioning of the market. In particular, although more customers considered switching suppliers in comparison with the situation when the Competition Commission reviewed the market in 2002, customers still appeared reluctant to actually switch to another bank, and some were not fully aware of either their current banking costs or the potential benefits of moving to another bank. Prior to the

[17] *Packaged, premium and current accounts*, Mintel, June 2009 (available from www.mintel.com)

financial crisis there was some evidence of new entrants, for example Irish financial institutions and non-bank providers, attempting to come into the UK SME lending market. These institutions suffered not only from the consumer stickiness set out above but from:

- information asymmetries compared with established providers who had a more intimate knowledge of customers and could price more effectively; and
- adverse selection problems as it was the riskier borrowers who had difficulty attracting finance that new entrants will attract in the first instance.

9.32 Following the financial crisis many of these new entrants have to an extent withdrawn from the UK SME market, no doubt the information asymmetries and adverse selection problems encouraged them in this decision.

9.33 On the positive side the lending commitments that the UK Government has agreed with RBS and Lloyds have helped to maintain lending levels to business. Under these arrangements an additional £27 billion of business finance will be made available on commercial terms in the 12 months from March 2009 (£16 billion from RBS and £11 billion from Lloyds). HSBC is expanding their corporate lending activities in Scotland[18] by 46 per cent to £744m in the four months to the end of April, compared with the same period in 2008, and Barclays has announced increased lending to businesses of £5.5bn in 2009 relative to 2008. More generally, even prior to the crisis challenger banks were increasing their market share by gaining business from the four major banks and the OFT in 2007 noted that SMEs are increasingly banking with more than one provider, which facilitates entry and expansion by smaller providers. The increased use of internet technology reduces the importance of a branch network and also facilitates entry.

Increasing competition in the UK banking market

9.34 The Government is firmly committed to more competition and choice in financial markets, as the best way to serve consumers and the wider economy. There are several important elements to maximise competition and choice in the banking market:

- first, facilitating a wider diversity of producers – large and small, local and national, corporate and mutual – to offer greater choice and competitive variety;
- second, new entrants and new technologies are often the "disruptions" that create greatest new competition - yet regulation can itself create barriers to market entry;
- third, entrants from foreign markets are important sources of new competition and the UK financial market is one of the most open in the world - although it is also the case that concentration in the UK market has increased partly as a result of the exit of some foreign firms over the past two years, so foreign entrants should not always be seen as offering a permanent step change to competition;
- fourth, competition barriers in UK retail financial services are not necessarily linked to market share. Instead, access to networks and greater consumer awareness are crucial factors; and
- fifth, Government intervention in these markets has inevitably created some distortions - albeit for the wider good of all market participants and the wider economy.

[18] "HSBC to take on Scotland's corporate banking giants", *Scotsman*, 18 June 2009

9.35 The Government believes that action is needed to tackle all of these issues. The rest of this chapter sets out actions under way and proposed for the future. In particular the Government sees the need for action in four key areas:

- action to ensure that the need to maintain market access is firmly embedded into financial sector rule making, including through the work of the FSA, the OFT and the EU;
- improving competition and choice by strengthening the role of mutuals;
- supporting social investment; and
- ensuring an orderly exit from the Governments various financial sector interventions.

Market access, competition and regulation

9.36 There are important interactions between financial regulation and competition, and between the respective regulatory bodies - the FSA and the OFT and Competition Commission. The FSA has duties to have regard to the effect of its actions on competition, set out in section 2(3) of the Financial Services and Markets Act (FSMA), such as a requirement to consider competition in the analysis it undertakes before proposing new rules. In addition, the OFT has a duty to keep the FSA's regulations and practices under review on competition grounds and may involve the Competition Commission, as set out in sections 160-162. These arrangements avoid the conflicts of interest that would occur if the FSA was responsible for competition policy decisions concerning firms that it was also regulating, and reflecting the different nature of the financial sector from, for example, the energy market, where Ofgem has taken on a role including a more explicit competition focus in the context of former nationalised industries was relevant.

9.37 It is vital that the arrangements between the FSA and OFT in particular work effectively. It is also particularly important that the FSA, when considering impacts of regulation on competition, considers not only competition between existing market players, but also the impacts on competition for potential new market entrants and emerging technologies. The Government welcomes FSA and OFT plans to strengthen cooperation on competition issues, including agreeing a Memorandum of Understanding to ensure that the OFT is actively involved in the process of developing regulation at an early stage. The FSA's Annual Report will, in future, incorporate a section on competition in the sector, including setting out relevant actions that it has taken.

9.38 Furthermore, given these points, the Government proposes that:

- the FSA should consider the impact on market access of all proposed regulatory changes and to specifically address this issue when conducting its cost benefit analyses on new proposals, so that the impacts on potential new entrants are taken into account; and
- the OFT should address market access as part in its annual updates of its Financial Services Strategy.

9.39 It is also important that this action at national level is complemented by action at European level to ensure that European legislation fully incorporates the potential impact on market entry of new regulatory proposals. The Government will work to ensure that market entry is specifically addressed in EU cost-benefit analyses on new legislative proposals. This has been, and continues to be, an important concern in the development of new technologies, such as electronic money.

9.40 In addition, given the importance of consumer-led actions, the Government will ask the Retail Financial Services Forum to consider measures that can be taken to address information asymmetries and encourage switching in retail banking markets.

Mutuals

9.41 Another way of encouraging choice and competition is to encourage and support alternative business models.

9.42 The Government has a long-standing aim of supporting the UK mutual sector to thrive and serve a wider section of the community. Together, mutual societies – building societies, friendly societies, industrial and provident societies (IPSs) and credit unions – across the UK have a combined membership of over 30 million and total assets of over £400 billion.

9.43 Most significantly, there are 53 building societies[19] in the UK with 23 million members and total assets of £385 billion, holding residential mortgages of around £240 billion, approximately 20 per cent of the UK market. Societies hold over £235 billion of savings balances, accounting for about 21 per cent of all such deposits in the UK. Some societies have diversified in recent years and offer a wide range of financial products and service, for example, current accounts, credit cards, ATMs, travel money, unsecured loans, insurance and estate agency services. The building society market in the UK is characterised by one very large society, a few medium-sized ones and a large number of small independent societies.

9.44 The mutual sector has not been immune to the pressures caused by the contraction of global credit markets and the crisis that has ensued, particularly for those firms diversifying into new and high-risk lending products – it is the Government's view, however, that the traditional mutual model has, on the whole, stood up well. The Government believes that financial mutuals can provide a robust alternative to financial services companies in the future. In order to have this strength for the future, it is important that the mutual sector has:

- good corporate governance;
- a modern legislative and regulatory framework; and
- access to capital and funding through modern markets;

Corporate governance

9.45 The financial crisis has thrown the spotlight on corporate governance, including the scope for shareholders to exercise their ownership rights and hold the board of a company to account. The Government asked Sir David Walker to review corporate governance for banks; this review has subsequently been extended to include non-bank financial firms.

9.46 Similar issues apply to the governance of mutuals. Indeed it is arguable that the lack of external pressure which firms face means that it is even more important to ensure effective governance for mutuals. Following a 2007 consultation, the Government is taking forward a number of measures to improve further the legislative framework for credit unions and Industrial and Provident Societies (IPSs), and achieve a level of parity with the company form. A Government-supported Private Members Bill[20], which is currently before Parliament, includes measures to improve the corporate governance of IPSs and credit unions. It will, for example, ensure that officers of IPSs are subject to similar sanctions as directors of companies and provide for the FSA to be given new powers to investigate IPSs. The Bill will rename IPSs as co-

[19] They are regulated by the Financial Services Authority and subject to building society legislation, principally the Building Societies Act 1986.

[20] The Co-operative and Community Benefit Societies and Credit Unions Bill ('The Wicks Bill')

operatives or community benefit societies and include measures to improve the corporate governance of IPSs and credit unions.

9.47 In the light of the Walker review, and FSA changes, for example, to the competence of non–Executive directors, the Government will consider what further, proportionate, changes should be made to the corporate governance regime for financial mutuals and bring forward proposals at the 2009 Pre-Budget Report.

Shared operating models

9.48 Across much of the rest of Europe, there are shared operating models in the mutuals sector, notably in France, Germany, the Netherlands and Spain. Though there are a wide variety of such models, typical features include sharing of treasury services and back office functions, and cross-guarantees, with varying degrees of integration. Though the impetus for any structural reform must come from the mutuals sector itself, the Government is interested in exploring the potential of these models (among others) for UK mutuals.

9.49 The Government will report at the pre Budget report on whether any of the continental models may help achieve economies of scale in the UK building society sector, and, if so, what are the barriers to moving towards shared operating functions, recognising the current characteristics of the UK building society sector as outlined above. To inform this work the Government seeks responses to consultation questions in Annex B.

A modern legislative and regulatory framework

Credit Unions, Industrial and Provident Societies and friendly societies

9.50 The Government has taken a number of steps in recent years, to reform the legislative framework for financial mutuals, and has future reforms planned. The Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 enabled one type of mutual to transfer its business to the subsidiary of another type of mutual, while protecting the mutual model.

9.51 The Government has implemented this provision for building societies, which helped pave the way for the merger between Britannia Building Society and Co-operative Financial Services. The Government now intends to implement this section of the Act for IPSs, and will consult key stakeholders shortly, with a view to implementation in the autumn.

9.52 The Government will also bring forward proposals to reduce administrative burdens on credit unions and IPSs, through a legislative reform order. Responses to the 2007 consultation highlighted the inability of IPSs and credit unions to make full use of electronic communications as an obstacle to their operational effectiveness. The Government therefore intends to make an Order under the Electronic Communications Act 2000 to remove obstacles to the use of electronic communications for, for example submitting statutory forms and communications with members. The Government is persuaded in principle of the case for making a similar Order for friendly societies. The use of electronic communications will help ensure parity with proprietary companies who do not face the restrictions currently imposed on credit unions, IPSs and friendly societies.

Review of the legislative framework for Northern Ireland credit unions and IPSs

9.53 Northern Ireland has its own legislative framework for mutuals. The Treasury announced in the 2008 Pre-Budget Report that it would undertake a review of the Northern Ireland framework, working closely with the Northern Ireland authorities.

9.54 The Treasury's report is published alongside this consultation paper. Subject to the agreement of the Northern Ireland authorities, and to public consultation, the Government is

minded to bring Northern Ireland credit unions within FSA regulation, while maintaining a distinctive Northern Ireland legislative framework and registration function. This would give members of Northern Ireland credit unions access to the Financial Services Compensation Scheme (FSCS), and greater freedom for the sector to provide services which meet the needs of their members, as are increasingly available in Great Britain, the Republic of Ireland, and other countries worldwide.

Financial compensation and IPSs

9.55 The Treasury review also sought to determine what lessons could be learned from the collapse of the Presbyterian Mutual Society (PMS) in November 2008. The Government does not believe that it would be appropriate to introduce a compensation scheme for IPSs generally, as this would be equivalent to guaranteeing shares in a company. However, the Government does want to improve disclosure, so that members understand clearly the nature of their involvement with societies. These issues are discussed in detail in the Annex and consultees views are sought, including on whether a Code of Practice on withdrawable share capital similar to that issued by Co-ops UK should be made statutory.

9.56 Although the Government does not believe as a general principle that investors should be compensated, it is mindful of the particular plight of PMS shareholders, and is setting up a working group to determine whether a solution can be found. The working group will operate under the leadership of the Chief Secretary to the Treasury; its members will include the Northern Ireland Office, and the Northern Ireland departments for finance and enterprise. The terms of reference for the group will be published shortly, and it will report to the Prime Minister in the autumn.

Access to capital and funding

Building societies

9.57 The current low interest rate environment poses a challenge for building societies, which generate most of their profits from the spread on mortgages. Building societies must raise at least 50 per cent of their funds from members and hold at least 75 per cent of their assets in loans secured on residential property.

9.58 The financial crisis and contraction in the wholesale funding markets has resulted in strong competition for remaining sources of funding, and higher overall funding costs for all lenders, including building societies. Mortgage spreads over bank rates and swap rates have widened[21], reflecting funding costs and the increased compensation required for credit risk.

9.59 The building society sector has historically been well capitalised[22], and generally regarded as resilient enough to successfully weather the storms of an economic downturn. Prior to the collapse of the Dunfermline Building Society, there had been only three building society failures in the previous 50 years.

9.60 As with other mutuals, the legislative framework for building societies has been modernised in recent years. The Government has also taken steps to enable building societies to benefit from support in the wake of the financial crisis.

9.61 Section 9B of the Building Societies Act 1986 prohibits building societies from granting floating charges over their assets. This restriction was introduced to protect members of building societies from the risk that secured lenders might exercise an inordinate degree of control over

[21] As set out in *Trends in Lending*, Bank of England, May 2009 (available from www.bankofengland.co.uk)

[22] Building societies had an average capital ratio of 11.87 percent in 2006. Source: *Building Society Statistics for 2006*, Financial Services Authority, May 2007 (available from www.fsa.gov.uk)

the management of the society, and is still desirable in relation to the general business activities of societies. Following consultation in 2008, the Treasury introduced legislation[23] to enable building societies to grant floating charges to the Bank of England in relation to the provision of liquidity support. The Government is now proposing a further exemption to Section 9B, to make it easier for building societies to raise money from Treasury bills or other securities issued by a central bank. The Government will consult on this measure over the summer.

9.62 The Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 contains a measure to increase the proportion of capital which building societies may raise in the wholesale markets, to 75 per cent, however the Government has decided that although it accepts the principle that building societies should have flexibility over their funding strategies it is not convinced of a need to implement this section in the current economic circumstances. The Government committed in January 2009 to reviewing the position in two years time. At that point, the Government will consider whether the current wholesale borrowing limit appears to be acting as a constraint on the ability of building societies to run their businesses effectively and, if so, whether the benefits of increasing the limit would outweigh any stability risks.

9.63 Societies are also constrained by their structure in their ability to raise capital, which until recently has been limited to retained profits and permanent interest bearing shares (PIBS), fixed interest securities quoted on the stock market. The nature of PIBS can act as a deterrent to a building society transferring its business to a company (including a subsidiary of another type of mutual), as PIBS generally lose Tier 1 status in such a transfer.

9.64 The Government wants to support the building society sector to weather the current crisis, and, in time, to expand to meet the evolving commercial realities of the wider contraction in wholesale funding. The Government is therefore considering other ways in which building societies can raise capital, to provide greater flexibility over capital structures.

9.65 The Government notes the decision of the holders of subordinated debt in West Bromwich Building Society to convert their holdings into Profit Participating Deferred Shares (PPDS), a new form of Core Tier 1 capital. The instrument shares some features with the company equity share – it enables the holder to receive a portion of the profits of the building society holding the instrument (with a corresponding risk that their stake could be written down if the society makes a loss), and enables that society to increase its core capital, giving it enhanced resilience to absorb future losses. PPDS are within the scope of existing building societies legislation and have been approved by the FSA.

9.66 Holders of the PPDS issued by the West Bromwich, like other shareholding members of the society, enjoy voting rights in the society, limited to one vote per institution irrespective of the number of shares held. This ensures that building societies issuing PPDS remain under the control of their members, in keeping with the spirit of mutuality. Additionally, by limiting investors' participation in an institution's profits, the instrument preserves the important principle that building societies should return profits to their members (primarily in the form of competitive mortgage and savings profits). Though the limits on profit participation and ownership that are written into the PPDS issued by the West Bromwich are important features in preserving the principles of mutuality, these features may have the effect of limiting the return that investors can expect from their holding. Any legislative or regulatory reform in this area will need to balance the needs of both investors and the societies themselves, ensuring that the sector remains competitive but also that societies have the capital they need to withstand any future economic turbulence. Given the size of most building societies and the limits both on the ownership control that PPDS holders can have on building societies and the share of the profits

[23] The Building Societies (Financial Assistance) Order 2008, S.I. 2008/1427, made under the Banking (Special Provisions) Act 2008.

these holders can expect, it is likely that retained profits will still play an important role for the majority of societies in building their core capital base.

9.67 The Government will convene an expert group of key stakeholders to advise on the strategic issues affecting building societies, including shared operating models and capital raising. The work of this group will inform any further changes needed to develop a sustainable strategic framework for building societies, including measures to support investment, and to enable building societies to build up additional core capital. The Government will report at the pre Budget report.

Industrial and Provident Societies

9.68 For many IPSs the primary mode of capital raising is through members' shareholdings, the withdrawable share capital. The Industrial and Provident Societies Act 1965 imposes a maximum limit of £20,000 that a member of an IPS can invest in one society. This financial limit restriction on share capital does not apply to Companies Act companies (including cooperatives registered as companies). Raising the limit would therefore ensure parity with companies and enables IPSs to attract investment.

9.69 The Government is already proposing to use a Legislative Reform Order to enable members to invest more than £20,000 in transferable shares. It will in addition consult later this year on increasing the withdrawable share capital limit in line with inflation in future, using its existing power in the Industrial and Provident Societies Act 1965. The Government believes that an increase in withdrawable share capital would create much needed scope for societies to raise capital, provide further investment opportunities for societies and increase the potential for the development of new markets.

Social investment

9.70 Social investment is defined as investment made for a social purpose in organisations that are committed to delivering benefits for society and the environment. The range and number of financial institutions that lend to or invest in the third sector has increased in recent years. Some of these, such as the high street banks, will lend to or invest in the third sector at a market rate of return, while others focus on lending to organisations that find it difficult to obtain finance from mainstream providers, again at market rates. Finally, some might accept a financial return that is lower than in a truly commercial arrangement, due to the additional social return that is generated by the third sector organisation. There are several finance providers now in the market that are experimenting with different ways of channelling investment to third sector organisations.

9.71 To support the growth of the social investment market, the Government is launching a consultation in the coming weeks on the design and functions for a Social Investment Wholesale Bank, and will report back with substantive proposals.

9.72 A Social Investment Wholesale Bank would be a mission-driven investment bank which could leverage additional private capital to support existing investors and lenders to the third sector. By working with existing investors and lenders at the retail level, a Social Investment Wholesale Bank would aim to increase the supply of investment capital in the third sector, and strengthen demand for finance and develop the social investment market. It would be a wholesaler of social investment finance, designed to support the long-term sustainability of a thriving third sector by enabling organisations to access the finance they need to grow, thrive and become more sustainable.

9.73 The Government and the FSA will consider whether the Social Investment Wholesale Bank should gain permission from the FSA to undertake a regulated activity under Part IV of FSMA.

9.74 Community Investment Tax Relief (CITR) aims to incentivise private investment from individuals and companies in financially excluded small and medium-sized enterprises within or serving disadvantaged communities. The relief is available to individuals and companies that invest in accredited intermediary organisations, Community Development Finance Institutions which in turn are required to onward invest in enterprises that operate within or for disadvantaged communities.

9.75 The Government will work to ensure that CITR continues to be as effective as possible at encouraging new investors into disadvantaged communities and at expanding levels of investment.

9.76 The Government will also look at how CITR fits with other mechanisms to support investment in disadvantaged communities, including, for example, the Enterprise Finance Guarantee which was extended in May to provide extra support to Community Development Finance Institutions by allowing them to access bank loans, worth up to £20m.

Box 9.B: The UK Innovation Fund

The UK Innovation Fund, announced on 29 June, will focus on investing in digital and life sciences, clean technology and advanced manufacturing. 'New Industry New Jobs' identified the issue that finance available to small and start-up businesses in these areas has been significantly reduced by the recession and it is vital to create a platform to provide the support to these businesses when they need it most. The Government believes private sector capital can be leveraged alongside Government investment to provide the scale of support required by the industry.

Consistent with the strategy for business support laid out in 'New Industry New Jobs', the Rowlands' Growth Capital Review is intended to identify if there is a structural problem in the provision of growth capital to small and medium enterprises, that has been exacerbated by the current recession. Established Small and Medium-sized Enterprises (SMEs) need patient, flexible capital to provide them with the support they need to contribute to UK economic recovery. The Review will establish whether this capital is unavailable to SMEs, especially in the current environment, and therefore whether Government should seek to intervene to provide that support.

The Government's exit strategies from short-term interventions

9.77 Governments around the world have taken necessary action over the past months to stabilise the financial system including capital funding and support. In many cases, Governments have taken ownership stakes in financial institutions.

9.78 This action has proved crucial to limiting the effects of recession on our economy. However, the impact of these measures on competition is not straightforward. On the one hand, these measure many have allowed firms to remain viable when they may otherwise have failed. On the other, all firms have benefited at a broader level from actions to support the stability of the system, and in many countries, including the UK, support arrangements have been offered across the market and priced in a manner intended to reflect the market. In the long term, it is clearly necessary to exit in an orderly manner from such interventions to promote competition in the UK.

9.79 The Government sees all of its measures to intervene in the financial markets to support financial stability and maintaining lending during the recession as temporary in nature. As soon as possible it will seek to exit from such interventions, as it wishes the see banks returning to full

private ownership and able to compete for customers as free standing businesses without any need for Government support. Such action will, of course, depend upon a full restoration of stable and liquid financial markets.

9.80 In some cases, the Government and the Bank of England have already set timetables or processes for withdrawing from its interventions to support banks, such as:

- the Bank of England's Special Liquidity Scheme (SLS) will end in January 2012. Between now and then the authorities will monitor the banks' progress in managing down their balance sheets and assessing other sources of funding;
- the Asset Purchase Facility (APF) is also operated by the Bank of England. Exit from the scheme contains two elements:
  - use of APF for monetary policy purposes, that is financing APF purchases through the issuance of central bank reserves: exit will be determined by the decisions of the Monetary Policy Committee over the pace with which to raise Bank Rate and sell assets in order to meet the monetary policy remit of targeting inflation. Subject to that, the MPC will have due regard for the impact of those sales on the operations of the Government's Debt Management Office;
  - use of APF to support corporate credit markets: exit will be determined by the Government in consultation with the Bank of England and subject to existing commitments to give notice. An important determinant will be evidence that corporate credit markets are functioning effectively in matching the supply and demand for finance;
- institutions will be able to access the Credit Guarantee Scheme (CGS) until it closes to new drawings at the end of 2009. Debt issued under the scheme must mature by no later than April 2014, at which point the Scheme will come to an end. The Government expects the amount of guaranteed debt to reduce in the period running up to April 2014. If market conditions improve substantially, the Government would also expect to see participants choose to place less reliance on the scheme earlier; and
- the duration of the APS will be consistent with the tenor of the relevant covered assets. The Scheme will terminate on the date specified in the applicable accession agreement or, as the case may be on the date of termination of a firm's participation. It should be noted that a firm could terminate its participation at any time in whole or in part with the prior consent of the Treasury.[24]
- The Asset Backed Securities Guarantee Scheme, which was made available to eligible banks and building societies at Budget 2009, will run for 6 months until October 2009. The duration of the guarantees may be up to five years.

9.81 The Government strongly supports the case for effective co-ordination of exit strategies internationally, though for example the G20 and EU and will be working with its partners internationally in coming months to achieve such an approach.

9.82 In the case of its shareholdings, the Government has stated clearly that it intends as soon as possible to fully return Lloyds Banking Group and RBS to the private sector. It is likely that this

[24] The APS has been agreed in principle but due diligence is ongoing ahead of contracts being finalised and the scheme is subject to regulatory and State Aid approvals.

will take some time before full divestment is possible, and the Government's current expectation is that such disposals will progressively reduce the Government's shareholding. The Government will decide upon its disposals strategy, taking account of its overall aims to protect and create value for the taxpayer as shareholder, with due regard to financial stability and will also act in a way that promotes competition. In implementing its approach, the Government will be guided by the advice of UK Financial Investments and its assessment of the most appropriate commercial strategy.

9.83 The Government will dispose of Northern Rock as soon as appropriate in a manner that will promote competition for retail services, secures the best possible return to taxpayers and ensures that Northern Rock will continue to increase its lending to homeowners.

A Primary legislation proposals

This annex presents the Government's firm policy proposals for new primary legislation, and sets out consultation questions. It covers the following measures:

1. Reforming regulatory institutions
   a. Formalising and strengthening the arrangements for institutional cooperation
   b. Strengthening the governance arrangements and statutory framework of the Financial Services Authority (FSA)
   c. Enhancing the FSA's powers
   d. Expanding the role of the Financial Services Compensation Scheme (FSCS)

2. Competitive markets that work for consumers
   a. Financial capability and Money Guidance
   b. Strengthening the FSA's consumer capability
   c. Swift and effective redress

1) Reforming regulatory institutions

a) Formalising and strengthening the arrangements for institutional cooperation

A new Council for Financial Stability

As set out in Chapter 4, the Government intends to legislate to create a new statutory committee – the Council for Financial Stability (CFS) – which will replace the Standing Committee. The Council will consist of the Treasury, the Bank of England and the FSA and will be chaired by the Chancellor of the Exchequer.

The objectives of the new committee will be to analyse and examine emerging risks to the financial stability of the UK's economy, and coordinate the appropriate response. The CFS will have regular meetings throughout the year, to discuss the authorities' assessment of systemic risk and to consider what action is needed. The Council will consider key publications – for example the Bank of England's six-monthly Financial Stability Reports, and the FSA's annual Financial Risk Outlook – to inform its deliberations.

The CFS will also meet as necessary to discuss particular risks to financial stability, involving specific sectors or firms, and to coordinate any regulatory action or intervention required.

To increase public transparency and accountability, minutes of the standing meetings of the CFS will be published. Market-sensitive discussions will remain confidential.

An annual report will be published and provided to Parliament, setting out in full the activities of the CFS. It will describe significant regulatory actions (for example those taken under the Banking Act 2009 and Financial Services and Markets Act 2000 (FSMA), including potential further developments to regulatory legislation, such as extensions to the scope of regulation). The CFS will consider the report prior to publication.

Since the onset of the crisis the Government, the Bank and the FSA have worked closely together to pursue reforms to strengthen EU and international regulation and enhance cross-border cooperation. The Treasury, Bank of England and FSA will need to continue to collaborate closely in pursuing the UK's interests, both in key international regulatory bodies, such as the FSB and the Basel Committee, and in the EU.

To this end, the Government proposes that an additional role of the CFS will be to discuss and coordinate the UK Authorities' position on EU and international financial stability and regulatory policy issues. The Government also intends to give the FSA a duty to promote sound international regulation and supervision, which would complement the Government's and the Bank of England's objectives in this regard.

The Government will establish Terms of Reference for the new Council, which will replace the existing Memorandum of Understanding.

The membership of the CFS will be limited to the three Authorities, but the Council will benefit from outside expertise via the external members of the governing bodies of the Bank and the FSA (in particular those members of the Bank's Court who also sit on the Bank's Financial Stability Committee). The members of these governing bodies approve the analysis and recommendations of their institutions in advance, and could, if appropriate, be invited by the Chancellor to participate in the meetings of the CFS.

Democratic accountability to Parliament

The Government will discuss mechanisms for increasing the democratic accountability of the CFS, given its role in public policy making and implementation, possibly through greater, Parliamentary scrutiny.

The Government notes the important role that the Treasury Select Committee has played throughout the events of the last two years in fulfilling this function. It is, of course, for the House of Commons to decide how the Treasury Committee may best fulfil its role. The Government will consult on options for broadening and strengthening channels of democratic accountability and will work with the Treasury Select Committee to consider whether and how emerging options should be implemented.

Consultation questions

1. What are the benefits in creating a more formal and transparent body to coordinate the authorities' more systemic approach to financial regulation? Do you have any views on the role and remit of the CFS?
2. To what extent would an annual report on key developments increase knowledge and awareness of significant regulatory actions taken under the Banking Act and FSMA? From your point of view, what areas would it be useful for this report to cover?
3. In addition to the input of non-executives from the governing bodies of the FSA and the Bank, what other ways could external advice and commentary be incorporated in this process?
4. What mechanisms might be used for enhancing democratic accountability? Is this important? Are there any risks that need to be considered – for example, around market sensitivity, or threats to consumer confidence?

b) Strengthening the governance arrangements and statutory framework of the Financial Services Authority

As described in Chapter 4, the Government is re-examining the FSA's statutory objectives and governance with the intention of supporting its greater focus on prudential supervision, greater attention to system-wide risks and providing explicit legal authority to take action to support financial stability.

The Government intends to legislate to provide the FSA with a more explicit financial stability objective, in order to clarify that the FSA's regulatory and supervisory approach should include an enhanced focus on monitoring, assessing and mitigating systemic risks across the financial system.

In the light of increased international focus on financial regulation, this objective will also establish that the FSA should take into account the impact of wider European or global financial stability concerns on its regulatory and supervisory decisions. In addition, the Government intends to legislate to create explicit duties for the FSA to have regard to the need to work internationally.

At present, the FSA is required to take into account the costs and benefits of any proposed action but it is not specifically required to consider the possible wider economic or fiscal costs of a decision not to act. In practice, this has meant that the focus of the FSA's cost-benefit analysis has been determined by its current statutory objectives. As discussed above, at present the FSA's objectives are focussed on consumers; therefore the FSA has concentrated on the immediate impact on market confidence and the direct costs to consumers of financial services. The creation of a new financial stability objective will clearly allow the FSA to take a broader range of impacts and costs into account. The Government will also amend FSMA to make clear that the FSA should consider the wider economic and fiscal costs of a failure of an institution when deciding between different possible courses of regulatory action.

Having updated the corporate governance arrangements and statutory objectives of the Bank of England through the Banking Act 2009, the Government is considering the formal accountability structures supporting the FSA's corporate governance. The Government is pleased that the Board of the FSA intends to undertake review of its effectiveness.

Consultation questions

5. What are the benefits of giving the FSA an explicit objective for financial stability?
6. What are the advantages and disadvantages of amending FSMA to make clear that the FSA must take into account any possible wider economic and fiscal costs in its decision-making?
7. What are the advantages and disadvantages of amending FSMA to place a duty on the FSA to promote sound international regulation and supervision?
8. To what extent would these proposals improve the FSA's ability to have a more systemic or macro-prudential approach to prudential regulation?

c) Enhancing the FSA's powers

The Government is taking steps to ensure that the FSA's objectives and powers are designed in a way that enables it to perform the extended role envisaged in the supervisory enhancement programme and the Turner Review effectively.

Section 138 of FSMA contains the power that allows the FSA to make rules – one of its main tools for regulating the financial sector. To complement the changes to the FSA's objectives, the Government proposes to amend this rule-making power so that it explicitly covers all the FSA's objectives, not just consumer protection.

The Government similarly proposes to legislate to amend these sections of FSMA to ensure that the FSA may use its own initiative variation of permission (OIVoP) and intervention powers for the purpose of fulfilling any of its objectives.

The Government has identified three areas of FSMA that should be examined further and strengthened to ensure that the FSA can take appropriate action. These are enforcement powers in relation to authorised persons and firms; enforcement powers to prosecute market abuse; and extended information gathering powers.

The Government proposes, within any limits set in EU law, to give the FSA:

- a power to suspend individuals or firms for misconduct; and
- a power to penalise individuals who perform a controlled function without FSA approval.

The Government believes that it is important that the FSA continues to have the ability to impose emergency restrictions on short-selling until broader independent powers are granted to the FSA to do so (see below). The Government therefore intends to extend the sunset clauses until 31 December 2011, via statutory instrument, before their expiry at the end of this year. It remains the Government's intention that the UK fully align with the EU regime in this area in due course – if the review of the Market Abuse Directive (MAD) provides satisfactory solutions in both maintaining a robust UK regime and minimising cross-border costs for UK companies.

The Government therefore proposes to amend FSMA so that the FSA's powers to take such emergency action to place restrictions on short selling and require disclosure of short selling are independent of its powers in relation to market abuse.

In parallel, the Government will provide the FSA with the appropriate powers to make rules regarding a permanent disclosure regime for short positions in UK stocks.

The Government will also work with the FSA to assess whether it is necessary for the FSA to have any additional or extended information-gathering powers; in particular, whether there are additional participants in the financial markets from whom the FSA may need to require information in order to carry out effective financial stability, or macro-prudential, analysis. This could also help inform the FSA of developments in financial innovation, including those outside the regulatory perimeter.

Consultation questions

9 Do you agree that the FSA's rule-making power and powers of intervention should be explicitly deployable in pursuit of any of its regulatory objectives and not just that of consumer protection?

10 To what extent will the FSA’s enforcement capability be enhanced by a power to suspend individuals or firms for misconduct?

11 To what extent will the FSA’s enforcement capability be enhanced by a power to penalise persons who perform a controlled function without the necessary FSA approval?

12 Are the Government’s proposed amendments to FSMA the best way of ensuring that the FSA can continue to take effective action to tackle abusive short-selling practices?

13 Can you identify areas where the FSA does not currently have sufficient power to request information that it requires in order to carry-out more system-wide analysis of the financial sector?

d) Expanding the role of the Financial Services Compensation Scheme (FSCS)

Chapter 8 discussed consumer protection and depositor compensation.

The Government believes that the FSCS' response to recent bank defaults showed that it could operate effectively outside its narrow formal remit by acting as an agent to deliver compensation to UK customers of financial services firms, including in the following circumstances:

- by acting as the single point of contact in the UK for deposit-guarantee schemes in other Member States;
- by acting as the UK agent for compensation schemes in other countries (including third countries) when they have to pay compensation to UK customers of financial services firms;
- by acting as paying agent in other cases when arrangements are put in place to make payments to UK customers of financial services firms.

The Government is considering including in FSMA a power to enable it to require the FSCS to act as described above in specific cases. The FSCS would not have to use its own funds (or raise levies) to make compensation payments under the new powers; the funds for this would have to be provided by the other scheme or persons responsible for paying compensation. The FSCS would also not be expected to bear any additional administrative costs that arose from this work.

Consultation question

14 What are your views on this proposal to expand the role of the FSCS?

2) Competitive markets that work for consumers

a) Financial Capability and Money Guidance

In chapter 8 the Government set out its vision of better-educated consumers who have the skills, motivation and confidence to make informed and responsible financial decisions.

The Government is taking steps to prepare for rollout of a national money guidance service from spring 2010 by bringing forward primary legislation as soon as possible, including taking a power to direct public funds to support delivery of Money Guidance.

The Government is also committed to ensuring that all relevant financial services firms are required to contribute to the costs of Money Guidance, as the Thoresen Review recommended. FSA-regulated firms already pay towards supporting financial capability initiatives, including the Money Guidance pathfinder, as part of the FSA levy and will contribute to the funding of Money Guidance in a similar way in future. However, some financial services firms do not come under the FSA levy as they are licensed solely by the OFT for consumer credit activities. The Government intends to take a power to bring relevant consumer credit firms into the funding base for Money Guidance. The Government is committed to introducing a proportionate and efficient levy regime for those consumer credit firms affected and will consult further on the detail of the scheme.

Consultation questions

15 What are the advantages and disadvantages of the relevant consumer credit firms contributing to the costs of Money Guidance?

16 The Government believes that some organisations, such as free and impartial debt advice providers, should be exempt from the levy on consumer credit licence holders – do you agree? Are there other cases where an exemption is appropriate?

17 What factors should be considered in designing an appropriate levy scheme for consumer credit firms?

b) Strengthening the FSA's consumer capability

In chapter 8 the Government set out its intention to bring forward primary legislation requiring the FSA to establish an independent consumer education and information authority.

The Government intends to legislate to:

- amend FSMA to require the FSA to set up the new authority and to set out in legislation the authority's specific functions and objectives in respect of consumer education and information provision;
- establish the authority's board and Chairman – it is intended that these should be appointed by the FSA, with the approval of HM Treasury in the case of the Chairman, ensuring however that the terms of their appointment will secure their operational independence;
- confer levy-raising powers on the authority to allow collection of revenues from FSA-regulated and OFT-licensed firms and allow it to receive a range of funding streams, including public funds;
- give the authority the ability to delegate functions where other organisations might be better placed to deliver; and
- provide the authority with statutory immunity in relation to the discharge of its functions.

Consultation questions

18 What issues need to be resolved to establish a successful consumer education authority set up by the FSA?

19 What are your views on the scope of the new authority? Should it also, for example, champion consumer interests and act as a consumer voice in financial services?

20 What are your views on the governance and funding proposals for the authority?

21 To what extent should the authority be independent of the FSA?

c) Swift and effective redress

Chapter 8 discussed customer complaints. One element of this is collective redress where the Government believes that the emphasis should remain on ensuring that firms compensate the consumer voluntarily. When that is not possible, and many consumers are affected in a similar way, there should be routes to collective redress that can deal with claims more efficiently, reduce the time that claimants may have to wait, and reduce the volume of individual cases dealt with by the courts or the Financial Ombudsman Service (FOS).

The Government therefore invites views on the case for legislating to:

- update the regulators' existing backstop powers to deliver collective redress; and
- introduce some form of collective action through which consumers can enforce their rights to redress.

Redress through the regulator

The FSA has existing powers to impose redress schemes on a firm-by-firm basis where a large number of consumers are affected. The power of the Treasury to initiate a collective redress scheme on a wider basis is set out in section 404 of FSMA. The Government believes there should be new powers for the FSA to require a firm or firms to make redress either on an industry-wide or firm-by-firm basis as appropriate.

The Government proposes to update FSMA with new powers to make redress powers more effective and capable of use in a wider set of circumstances. One option for achieving this is to give the FSA the power to establish a review of past business failure, without requiring the involvement of the Treasury or Parliament as FSMA currently requires. Any scheme of redress would be likely to require firms to ascertain their liability to individual persons, calculate loss and pay compensation to such persons, following parameters set by the compensation scheme. This might apply generally, or on an opt-out or opt-in basis.

Further changes to enhance the effectiveness of section 404 would include expanding its scope from breaches of FSA rules to areas where the FSA has regulatory responsibility. This would future-proof it and, for example, bring payment services and potentially some other legislation with consumer protection aspects within scope. It could extend to breaches of contract law. It could also extend beyond authorised persons to other persons over whom the FSA has regulatory responsibility, but who are not necessarily authorised by the FSA. The key elements are:

- a power for the FSA to make rules, subject to normal accountability requirements such as consultation, requiring firms to conduct an investigation in order to establish their liabilities to consumers and to pay compensation;
- the parameters of this scheme would be set out in the rules;
- the power should extend to regulatory breaches in addition to breaches of FSA rules, and it may also be extended to include breaches of the general law;
- there will be no requirement for Treasury or Parliamentary approval; and
- any scheme to apply on an opt-out or opt-in basis according to the circumstances.

Redress through the courts

A court-based group action mechanism would free consumers and firms to some extent from dependence on the regulator or FOS. Its existence would provide an incentive to negotiate a

solution before consumers took a group action through the courts. There would be little risk that firms might be forced to settle to avoid expensive litigation, or a risk that action might be counter to the general good, if an action were subject to the approval of a gatekeeper, such as the FSA.

The potential solutions range from a better process for a representative body to bring an action; a new third party alternative dispute resolution body dedicated to settling group cases, or facilitating action through the courts; and a dedicated tribunal service with the expertise to handle financial services class actions. Any solution will require primary legislation.

There is already provision in English law for a representative action, but it only permits a party to represent other parties where they all have the same claim, and only subject to strict legal requirements. Test cases, Group Litigation Orders (GLO) and the consolidation of actions are designed to manage litigation time and costs and to assist in the resolution of shared issues. They do not, however, allow groups to be represented. No representative body can bring an action merely by virtue of a GLO.

The Government believes there is a case for a new collective redress mechanism in the financial services sector. A proportionate response rules out creating an expensive new tribunal or alternative dispute resolution body. It points to giving the FSA a new power to appoint a nominated, qualified representative body or person, to pursue a representative action through the courts, where the FSA believes there is evidence of a breach of its rules. The Government is considering whether it is desirable for the power to extend beyond breaches of rules. The court would establish liability and order compensation to be paid to consumers as directed by it.

The Government expects that a representative action would be available to an FSA-nominated person in exceptional cases, where the FSA, taking account of FOS decisions as appropriate, took the view that FOS or restorative justice using FSA powers were inappropriate or unavailable. There would need to be a sufficient number of potential claimants and reasonably uniform claims. The case would need to be supervised and approved by the court, which may need to decide whether it should be based on automatic inclusion of eligible claimants with the possibility of opting out. A representative body would not receive public funding and might be required to provide security for legal costs.

Special consideration will need to be given to the position of Scotland as a representative action in the context of financial services may require the modification of court procedures which in Scotland are a matter for Scottish law. The implications for court procedures in Northern Ireland will also need to be considered.

Consultation questions

22 How can better routes to collective address be achieved, which deal with claims more efficiently, reduce the time that claimants may have to wait, and reduce the volume of individual cases dealt with by the courts or FOS?

23 What are the pros and cons of updating FSMA section 404 through expanded new powers for the FSA to which different procedures will apply as proposed?

24 What are the pros and cons of introducing a new representative action process where there is evidence of a breach of FSMA or FSA rules, and should this extend to breaches of other requirements in the area of FSA supervision?

25 How should such a representative action process be structured?

26 The Government invites views on the potential costs and benefits of its collective redress proposals.

B Areas for discussion

This annex presents the policy areas in which the Government is seeking to engage in wider discussion and consultation before presenting firm policy proposals. The consultation questions in this annex seek to promote this initial discussion.

It covers the following areas:

1 Managing systemically significant firms;

2 Competitive markets that work for consumers:

   a. Barriers to entry and encouraging new entrants to the retail banking market

   b. Access to simple, transparent products

   c. Mortgage insurance

   d. Financial Services Compensation Scheme governance and accountability

   e. Strengthening crisis management and depositor protection across the EU: single point of contact

3 Strengthening mutuals

   a. Improving building society governance

   b. Financial compensation and Industrial and Provident Societies

1) Managing systemically significant firms

The challenges of dealing with systemically significant institutions are discussed in Chapter 5. Progress in other areas of regulation and supervision will help to address wider systemic risks of individual firms, including:

- stronger market discipline;
- better micro prudential regulation; and
- continued progress on strengthening market infrastructure.

However, in order to address the wider systemic risks of individual large, complex and interconnected financial institutions, the Government proposes to go further and ensure that the systemic nature of individual firms is reflected within the regulatory and supervisory process.

Firstly, the Government will work with the FSA to ensure that all banks are required to prepare for their own resolution. It will be important that firms establish clear contingency plans for action in times of failure. This may include establishing clear lines between deposit-taking and other banking operations.

Secondly, in addition to more intrusive and systemic prudential regulation that will be introduced for all firms, stricter regulation and supervision will be levied on systemically significant firms. This will ensure that system wide costs associated with individual firm failure are internalised via more stringent capital requirements, liquidity management and supervision on such firms.

There are significant challenges with implementation of this approach, most importantly in the identification and classification of the level of systemic risk posed by individual firms, and the Government will work with the FSA and the Bank of England to develop a framework for how this can be applied in practice. The Authorities will also continue to work to establish the appropriate institutional arrangements for the implementation of the framework. For example, tackling the question of which institution would be the arbiter of any list and how often it would be updated. It will be essential that this framework reflect international agreement and discussion on these issues.

Consultation Questions

1. Do you agree that the systemic significance of a financial institution should be explicitly linked to regulatory capital requirements?
2. How should systemically significant institutions be categorised? For example, should there be a fixed list or a sliding scale of importance, how often should such a list be updated, and should any list of systemic significance be made public?
3. Can you identify any other important challenges to implementing stricter regulation on systemically significant institutions?
4. Do you agree that banks should be required to establish more detailed contingency plans in times of failure?

2) Competitive markets that work for consumers

a) Barriers to entry and encouraging new entrants to the retail banking market

Chapter 9 considered competition in the retail banking market in detail. While the change in market dynamics as a result of the financial crisis does not appear to have damaged competition in the short run it is nonetheless important to ensure that smaller players and new entrants are able to become effective competitors to drive competition, efficiency and innovation over the medium term.

Analysis by the Office of Fair Trading and the Competition Commission highlights six barriers that prevent entry to the UK retail banking market: the need to establish a branch network; a successful brand; a low customer churn rate; access to payments networks; regulatory requirements; and access to customers' credit risk information.

The Government welcomes views on whether these factors are the principal issues and on their relative priority. It further discusses possibilities for encouraging competition in terms of:

- the number of customers willing to switch accounts – including portability of bank account numbers, transparency of financial products and the importance of financial capability. In particular, measures should address not only consumers' ability but also their incentives to switch providers; and
- the opportunities of technology to provide new and innovative ways of banking and help to overcome the barrier to entry.

The Government recognises the importance of the regulatory response to the financial crisis not inadvertently creating barriers to new players entering the banking market. To this end the Government is considering requiring:

- the FSA to consider the impact on market access of all proposed regulatory changes and to specifically address this issue when conducting its cost benefit analyses on new proposals; and
- the OFT to address market access as part of its annual updates of its Financial Services Strategy.

Consultation responses to the questions below will inform policy development in these areas, and the Government will also consult further by the end of the year.

Consultation questions

The Government is seeking views on a range of key issues:

5. what steps could the Government take to increase competitive pressures in the market, to the benefit of consumers?
6. in addition to the barriers to entry identified by the OFT and the Competition Commission, are there further barriers faced by potential retail-banking providers?
7. how can the Government and industry facilitate easier account switching in the retail banking sector?
8. what additional work would be needed to ensure that the infrastructure to support faster payouts in the event of bank failure could also support account portability?
9. with the development of new technologies, where might new entrants to the retail banking market come from and how can consumers be encouraged to take advantage of it?
10. do you support the Government's proposals to embed facilitating market entry into medium-term financial sector policy making by requiring the FSA and OFT to specifically address the issue in: Cost Benefit Analysis on new regulatory proposals; and the OFT's annual updates to its financial services strategy?
11. would you support requiring the OFT to consider enforcing the adoption of industry-wide disclosure standards to ensure consumers are well-equipped to make decisions about their financial affairs and to switch suppliers?

b) Access to simple, transparent products

For many products, the sheer complexity and volumes of 'small print' act as a deterrent and can mean that, without regulated advice, people buy the wrong product or fail to engage with financial services at all. Ron Sandler's 2002 review of the savings and investment market[1] found a combination of excessive complexity, distribution dominated by Independent Financial Advisers (IFAs) paid by commission, and low levels of financial capability. Together, these had the effect of preventing competitive forces from working to drive the improvements in quality and reductions in price that would happen in other markets.

Innovation seems to have led to the development of large ranges of subtly different products rather than to increasing market focus on the types of products which consumers might reasonably be expected to want. In a cash ISA, for example, such features might include high and stable interest rates and easy transferability; for protection insurance it might be a low price and an absence of hard-to-understand exclusions; and for a pension perhaps low charges and easy fund switching.

The Government has twice introduced measures intended to improve access to basic financial products. In 1998 it introduced CAT (Charges, Access, Terms) standards and in 2005, following the Sandler report, these were replaced with 'stakeholder' products, a suite of simple products with defined characteristics (stakeholder pensions were introduced in 2001 and integrated into the wider stakeholder suite in 2005).

The Government's overall objective in this work has been to try to ensure that where people come to financial markets seeking a basic product, it is easy for them to identify a simple, accessible and value for money option which has the basic features most consumers would be expected to want. Even where they end up choosing a less basic option (which may well be in their interests) there is a benefit in being able to compare whether additional features are worth the extra charges or complexity. This overall objective should be complementary to work on financial capability; higher levels of financial capability should enhance people's ability to recognise their own financial needs and therefore increase demand for basic products, although arguably, without intervention, financial market complexity will always outpace consumers' capability.

Both stakeholder and CAT standards imposed requirements on charges, accessibility and terms. However, neither were popular with the financial services industry, which argued that charge caps made the products unprofitable and consumers did not demand them. This is backed up by sales data for products in markets with a high degree of choice – according to ABI data, less than a quarter of the ISAs sold in 2007 by ABI members were stakeholder ISAs.

Stakeholder child trust funds and stakeholder pensions have sold better. Almost three quarters of parent-selected child trust funds are stakeholder products. This may be because the information parents receive about CTF makes clear that there is a stakeholder option, so they always have the opportunity to make a choice between stakeholder and non-stakeholder. Similarly, for stakeholder pensions financial advisers are required by an FSA rule[2] to explain in writing to a customer why the pension they want to recommend is at least as suitable as a stakeholder product. This often means having to justify higher charges. For the other two products in the stakeholder suite – the medium-term investment product and the deposit account - a wide range of similar products exists and there is no requirement to make consumers aware of the stakeholder option. This suggests that in order for product regulation

[1] *Sandler Review: Medium and Long-Term Retail Savings in the UK*, Ron Sandler, July 2002 (available from www.hm-treasury.gov.uk)

[2] Rule COBS 19.2, known as RU64 (see the *The Conduct of Business sourcebook*, Financial Services Authority, available from www.fsa.gov.uk)

to succeed in its objective of broadening access to this type of product, there needs to be some way of ensuring consumers know they are available.

Next steps for policy

While the stakeholder and CAT standard initiatives were partially successful, there is further to go. The disadvantage of the detailed product regulation on which the stakeholder suite is based is that it requires the Government to design products. This is not something public authorities are generally good at. It also stifles innovation. The Government therefore believes that product regulation should leave product design to the financial services industry without compromising consumer protection. This also means recognising that there is a role for products which are more expensive, more complex or less accessible than the most basic products.

An ideal system would therefore allow freedom over product design, while at the same time guiding people who would be best served by basic, cheap and accessible products in that direction and ensuring that wherever people do choose other options, they know about the basic alternatives.

The Government welcomes views on how best to achieve this. An alternative to the stakeholder approach – whereby products have to meet all the criteria to comply – would be a more nuanced system of labelling where product disclosure included measures of compliance on a variety of different characteristics, similar to CAT standards. There may be lessons to draw here from the successful use of a traffic light system in food labelling. The Government welcomes views on how labelling of financial products could be reformed to deliver similar outcomes in terms of simplicity and clarity for consumers.

Range of products

Consistent with the Government's aim of broadening easy access to financial services, it would like the range of products covered to include those which serve the most basic and widespread consumer needs. The focus of the stakeholder and CAT standard initiatives was on saving and investment products, although there was also a CAT standard mortgage. There is a question over whether this is the right focus. More basic needs might be served by, for example: current accounts; protection insurance; deposit accounts or pensions. Non-pension investments are less widely demanded. For example, of the 18 million people who currently save in an ISA, 11 million, or 61 per cent, invest only in cash[3]. It may be that for many people, apart from pension saving, their saving priority would be precautionary saving (setting money aside to meet unpredictable expenses or compensate for loss of income). This need would often be best served by deposit accounts or protection insurance.

Furthermore, establishing simplified disclosure standards for investment products brings obvious challenges, particularly around risk disclosure, which have proved difficult to address in the past. There is also work at the EU level to develop a harmonised approach to risk ratings for investment products. At this stage, the Government is inclined not to focus on non-pension investment products but instead on those products which are more widely used.

Compulsion

There is a question over whether any new labelling system should be voluntary or compulsory. Compulsion would pose challenges, particularly in defining the affected products and ensuring compliance with relevant EU law. However, there is a risk that a voluntary scheme would not work – for products which would be rated as complex or expensive, there would be a strong

[3] Source: HMRC

incentive on providers not to provide a rating at all. The Government is therefore inclined to work towards a compulsory scheme.

Next Steps

The Government intends to undertake further analysis, including determining what can be learned from the experience of CAT standards and stakeholder products, and whether product labelling in other markets may be transferable to financial services. The Government will also look at what consumers understand by 'basic' or 'simple', what features they would like to see included in a simplified disclosure system for different products, and which labelling system might work best.

The Government will ask the Retail Financial Services Forum to look at this issue in more detail, informed by views on the consultation questions below, and the analysis it will undertake over the coming months. It will issue a more detailed consultation on this subject by the end of the year.

Consultation questions

12 Would simplified labelling help consumer understanding of financial products? What lessons can be learned from the traffic light system of food labelling and how can these be applied to financial products? Should such labelling be compulsory?

13 Which products would – and would not – be suitable for simplified labelling? Is it possible to establish a single system of disclosure for a diverse range of products?

14 Should price be benchmarked? Should there be disclosure to help people identify products which are relatively expensive?

15 Why do some existing simple products not sell well?

16 Should the Government extend the concept underlying RU64 to other products – i.e. require firms to demonstrate why a complex or expensive product is better than a simpler or cheaper alternative?

17 Who should set benchmark standards for products?

c) Mortgage insurance

Chapter 8 covered discussion of mortgage insurance.

Some countries have adopted alternative models for mortgage insurance provision, for example Canada, where mortgage insurance is compulsory for all mortgages above a lower limit and below a maximum proportion of a home's value.

Some UK stakeholders have proposed that the Government considers the benefits of international models like Canada. The Government is interested in the lessons that may be learnt from the experiences of other countries, and invites stakeholder views, and will update at the Pre-Budget Report.

Consultation questions

18 Are there barriers to the provision of mortgage insurance in the UK?

19 What are the advantages and disadvantages of the Canadian model of mortgage insurance?

d) Financial Services Compensation Scheme governance and accountability

As set out in Chapter 4, the existing arrangements for governance and accountability of the FSCS have worked well. Nevertheless, as announced in Budget 2009, the Government will bring forward proposals regarding the governance and accountability of the FSCS to ensure that it is best able to respond to the challenges that its new roles and responsibilities, and the changed environment for financial stability, will bring.[4]

Consultation questions

20 Do you have any views on how the governance and accountability of the FSCS can be strengthened to help it successfully deal with these new challenges?

[4] *Budget 2009: building Britain's future*, HM Treasury, April 2009, p.68, paragraph 3.70 (available from www.hm-treasury.gov.uk)

e) Strengthening crisis management and depositor protection across the EU: single point of contact

Chapter 8 discussed depositor protection across the EU.

The Government believes that the EU should move towards a system in which host State schemes would always act as the single point of contact for depositors in their States, irrespective of which scheme had the ultimate liability to pay for the compensation given to depositors. This would probably require some greater degree of harmonisation between deposit-guarantee schemes. It is nonetheless compatible with a range of potential arrangements varying from a simple contact point for home State schemes, through acting as claims agents to processing claims and paying compensation on behalf of home State schemes.

Consultation questions

21 Do you agree that a single point of contact would be a suitable way of handling cross-border compensation issues in the EU? If not, why not and what alternative would you suggest?

22 How should a single point of contact operate?

23 Should there be more or less harmonisation of EU deposit-guarantee schemes?

24 What are your views on the possible introduction of a pan-EU deposit-guarantee scheme?

3) Strengthening Mutuals

a) Improving building society governance

Chapter 9 discussed building society governance.

Across much of the rest of Europe, there are shared operating models in the mutuals sector, notably in France, Germany, the Netherlands and Spain. Typical features of such models include sharing of treasury services and back office functions, and cross-guarantees, with varying degrees of integration. The Government is interested in exploring the potential of these models for UK mutuals.

The Government will conduct analysis on whether any of the continental models may help achieve economies of scale in the UK building society sector, and, if so, what are the barriers to moving towards shared operating functions. It will report at the Pre-Budget Report.

Consultation questions

25 What features of shared operating models could be applied to the UK building society sector?

26 What are the barriers to shared operating models?

27 What legislative or other changes would be needed to make such models effective in the UK?

28 Are there other measures the sector or Government should consider to achieve the long-term aim of a robust, thriving building societies sector?

b) Financial compensation and Industrial and Provident Societies

Chapter 9 noted that the Treasury's Review of the legislative framework for credit unions and industrial and provident societies in Northern Ireland has been published.

The Treasury review sought to determine what lessons could be learned from the collapse of the Presbyterian Mutual Society (PMS) in November 2008. IPSs across the UK are not regulated by the FSA, and therefore are not covered by the FSCS, unless they provide financial services which require FSA authorisation. A member's investment in the withdrawable share capital of an IPS is not, therefore, protected by the FSCS in the way that deposits with banks, building societies and credit unions are. In the case of the PMS, it seems possible that members did not understand that their deposits with the Society were at risk in the same way as shares in a company. Although PMS advertising material did specify that members would be buying shares in the society, it also gave the strong impression that their money was safe.

The Government does not believe that it would be appropriate to introduce a compensation scheme for IPSs generally, as this would be equivalent to guaranteeing shares in a company. However, the Government does want to improve disclosure, so that members understand clearly the nature of their involvement with societies.

IPSs are to a large extent exempt from the full provisions of the financial promotions regime, and the Prospectus and Money Laundering Directives. However, the Government believes it would be desirable for IPSs to comply voluntarily with some of these provisions as a matter of best practice, and it may be that a compulsory regime is required.

The Code of Practice on withdrawable share capital issued by Co-ops UK sets out some minimum standards of best practice to be observed by all IPSs[5]. Among other things, the Code requires IPSs to inform members and prospective members in writing 'at the earliest opportunity' as follows: "This society abides by a code of practice which requires it to provide a statement to its shareholders of the nature of their investment and any change affecting it. The position you occupy as a shareholder of x society is no different from that of a shareholder in any other corporate body in the sense that, if x society fails, you may not have all, or any, of your investment returned to you..."

The Government considers that this Code is a useful start to complying with the spirit of the Directives and financial promotions regime, by requiring IPSs to explain to members the nature of their investment as well as satisfy themselves about the identity of any persons seeking to operate a withdrawable share account to assist in protecting their members and themselves against fraud.

The Government believes that the changes in train described above will help modernise the legislative framework for credit unions, IPSs and friendly societies in Great Britain, allowing them to serve their members more flexibly, while at the same time strengthening corporate governance to improve transparency and engender investor confidence.

[5] The main representative trade body for cooperatives in the UK.

Consultation questions

29 What is the best way of ensuring that IPSs convey to their members the nature of their investment?

30 Should a Code of Practice on withdrawable share capital be made statutory?

31 Are there specific measures the Government might take to help transparency and disclosure?

32 Are there other measures that the Government should consider to enable credit unions, IPSs and friendly societies to thrive?

Summary of impact assessment

What is the problem under consideration? Why is government intervention necessary?

The Government intervenes in financial markets to ensure they operate stably, efficiently and fairly. Intervention helps address a number of market failures including asymmetries of information between buyers and sellers, high barriers to entry, and externalities which arise when the social costs of failure of financial institutions exceed private costs.

Recent disruption has highlighted serious failures in the global financial regulatory system. In particular, deficiencies have emerged in governance and risk management in the institutional investment chain, quantity and quality of capital and liquidity of assets, and in regulation's ability to minimise systemic risk.

Major financial institutions have failed across the world, and consumer and investor confidence in markets has significantly declined. Longer-term interventions are now are needed to ensure a similar disruption cannot occur in future.

What are the policy objectives and the intended effects?

The policy objectives of the government's proposals are to:

- strengthen financial regulation to ensure it is fit for purpose and capable of adapting to innovative and evolving markets;
- reduce the impact of the failure of financial firm and prevent the consequences spreading to the rest of the financial sector and the wider economy;
- boost consumer trust and confidence in financial markets;
- improve efficiency and competition in financial markets; and
- strengthen regulators and the international regulatory framework.

What policy options have been considered?

A number of policy options have been explored to address the objectives above, including the option to do nothing. The following impact assessments set out the options that have been explored, likely costs and benefits, the preferred option selected, and the evidence base to support this proposal.

The consultation also proposes a number of areas where we intend to consult at a later stage on proposals for intervention. The full impact assessments, available on the Treasury's website, set out a timescale for this.

Will the policy be reviewed?

The effectiveness of all the proposals made in this consultation document will be subject to review in the light of consultation responses received. In addition, individual impact assessments set out any timescale for review.

Summary of costs and benefits

The time period used for present value calculations is 10 years unless otherwise specified.

Table C.A: Summary of costs and benefits

Policy proposal	Total cost (PV)[1]	Total benefit (PV)	Net benefit (NPV best estimate)
Additional powers for FSA to suspend and fine certain persons	£9m	£31m	£22m
Short-selling powers	£61m	£912m - £9,176m	£4,132m
National roll-out of money guidance (Time period = 52 years)	£1,374 - £2,659m	£24,662 - £27,914m	£24,248m
Consumer education body (Time period = 52 years)	£24m		
Collective redress	£452m	£1,549m	£1,097m
Expanding the role of FSCS to facilitate payment to UK customers if foreign banks default.	N/A	£1m	£1m

The full impact assessments of these proposals are available on the Treasury website – www.hm-treasury.gov.uk

[1] All sums have been rounded to the nearest £1m

D How to respond

This paper is available on the Treasury website at www.hm-treasury.gov.uk. For hard copies, please use the contact details below.

The Government invites responses to the consultation questions in Annexes A and B. Responses are requested by 30 September 2009, during which time the Government will also engage directly with relevant stakeholders.

Please ensure that responses are sent in before the closing date. The Government cannot guarantee to consider responses that arrive after that date.

Responses may be sent by email to: banking.reform@hm-treasury.gov.uk

Alternatively, they can be posted to:

Reforming Financial Markets consultation responses
Financial Regulation Strategy
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

When responding, please state whether you are responding as an individual or on behalf of an organisation

Confidentiality

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act (FOIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004).

If you want the information that you provide to be treated as confidential, do mark this clearly in your response. However, please be aware that under the FOIA, there is a Statutory Code of Practice with which public authorities must comply and which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain why you regard the information you provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances.

In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded unless and explicit request for confidentiality is made in the body of the response.

Code of practice for written consultation

This consultation process is being conducted in line with the Code of Practice (http://www.berr.gov.uk/files/file47158.pdf) which sets down the following criteria:

- When to consult. Formal consultation should take place at a stage when there is scope to influence the policy outcome.
- Duration of consultation exercises. Consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.
- Clarity of scope and impact. Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
- Accessibility of consultation exercises. Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.
- The burden of consultation. Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
- Responsiveness of consultation exercises. Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
- Capacity to consult. Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

If you feel that this consultation does not fulfil these criteria, please contact:

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E

Abbreviations and glossary of terms

Table E.A: List of abbreviations

Abbreviation	Term in full
ABS	Asset backed securities
APF	Asset Purchase Facility
APS	Asset Protection Scheme
BCBS	Basel Committee on Banking Supervision
CCP	Central counterparty
CDS	Credit default swaps
CEBS	Committee of European Banking Supervisors
CESR	Committee of European Securities Regulators
CFS	Council for Financial Stability
CGS	Credit Guarantee Scheme
CPI	Consumer Price Index
CPRMG III	Counterparty Risk Management Group III
CPSS	Committee on Payment and Settlement Systems
CRD	Capital Requirements Directive
ECB	European Central Bank
ESF	European Securitisation Forum
EWE	Early warning exercise
FOS	Financial Ombudsman Service
FRC	Financial Reporting Council
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSC	Financial Stability Committee
FSCS	Financial Services Compensation Scheme
FSF	Financial Stability Forum, the successor to the FSB
FSMA	Financial Services and Markets Act 2000
FSR	Financial Stability Report, as produced by Bank of England
G20	A group of twenty Finance Ministers and Central Bank Governors representing nineteen countries plus the European Union
IASB	International Accountancy Standards Board
IAIS	International Association of Insurance Supervisors
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions (IOSCO)

Abbreviation	Term in full
ISDA	International Swaps and Derivatives Association
LTV	Loan to value
MPC	Monetary Policy Committee within the Bank of England
MOU	Memorandum of Understanding
OMG	Operations Management Group, a group of regulators, led by the New York Fed, of which the FSA is a member
ONS	Office for National Statistics
OTC	Over the counter
RMBS	Residential mortgage backed securities
SEP	Supervisory Enhancement Programme within the FSA
SIV	Structure investment vehicle
SRR	Special resolution regime
UKFI	UK Financial Investments Limited (UKFI)
VAR	Value at risk

Table E.B: Glossary of terms

Term	Explanation
Banking Act 2009	received Royal Assent on 12 February 2009 and is a major reform in reducing the impact of a bank failure. The Act builds on existing arrangements to enhance the ability of the Treasury, the FSA and the Bank of England to deal with crises in the banking system, to protect retail depositors and to maintain financial stability.
bilateral collateralisation	collateral provided within a bilateral trade (trade between two parties transacted over the counter)
central counterparty (CCP)	an entity that will stand in the middle of every trade of a specified set of contracts for example those which are transacted on a particular exchange
clearing	the process of transmitting, reconciling and in some cases the confirmation of payment orders or security transfer instructions of trades prior to settlement. This may also include the netting of instructions of instructions and the establishment of final positions for settlement.
collateral	an asset that is accepted by another party in order to secure an obligation of the collateral provider with that party.
counterparty exposures	the credit risk of a counterparty to a transaction entered into, i.e. the risk that a counterparty will not settle an obligation for full value when due.
core funding ratio	ratio of sources of funding that are particularly reliable, and therefore sustainable throughout the economic cycle, to total funding.
credit default swaps (CDS)	a swap contract in which the buyer makes a series of payments to another party, the seller, in exchange for a payoff in the case that a credit instrument - typically a bond or loan - goes into default. This is similar to buying insurance against default risk.
deleverage	reducing the level of indebtedness of a firm relative to the assets it holds.
dynamic reserving	building provisions against future losses, by taking into account not only incurred losses but also other potential future losses when determining a firms profits. This policy is employed in some countries, and allows firms to build up buffers of resources during good times in order to absorb losses in bad times.

Term	Explanation
FSMA	Financial Services and Markets Act 2000 (FSMA) created a single financial regulator – the Financial Services Authority (FSA) – with powers to regulate a wide range of markets and financial institutions independently.
Glass-Steagall Act 1933	provisions within the 1933 US Banking Act that created a separation of banking activities between commercial and investment banks. These measures were withdrawn in the US in the late 1990s.
interest rate swaps	a swap contact where two parties exchange interest rate payments on a notional capital value, this will usually involve a fixed interest rate payment in exchange for a floating interest rate payment.
leverage	also known as the gearing of an institution, which is the ratio of long term debt funding to all long term funding.
leverage ratio	ratio that expresses a company's capital gearing, or leverage. These can be calculated from either the balance sheet or the profit and loss statement; a common example is debt as a percentage of equity. This is a non-risk-based measure.
loan to value ratios	the ratio of the loan amount to the asset value the loan is used to purchase sometimes expressed as a percentage. For example, the ratio between mortgage size and the appraised value or sales price of a purchased house.
MOU	the Memorandum of Understanding governs the operational aspects of the UK's system of financial regulation. This sits alongside legislation such as FSMA and the Bank of England Act 1998 and establishes a framework for co-operation between the Authorities in the field of financial stability, where each member of the Tripartite has separate, but complementary roles. The MOU sets out the division of responsibilities as based on four guiding principles; accountability; transparency; lack of duplication; and regular information exchange.
open market operations	the purchase or sale by the central bank of(OMO) government bonds in exchange for money, this is a tool used to conduct monetary policy.
over the counter (OTC)	a transaction between two parties that take place away from an exchange, i.e. they are "over the counter" and normally involve non-standard/ bespoke contracts.
securitisation	the process of transforming assets into securities, this involves one party "the originator", selling a pool of assets to a special purpose vehicle (the issuer) who finances the purchase by packaging the cash flows from these assets as tradable financial instruments (securities) which are sold on to investors.
settlement	the process that discharges obligations in respect of funds or securities transfers between two or more parties. This will occur after the clearing process.
Structured Investment Vehicle (SIV)	structured investment vehicle, an off balance sheet vehicle that raises finance by selling asset backed securities.
trade repository	used by regulators and clearing houses for recording trade activity and ownership of securities.
tranche	within securitisation, this refers to the different classes of debt instrument which are created from the same asset pool but have different risk return profiles. The lower tranches will bear a higher level of risk.
The "Authorities"	the three authorities that form part of the UK's system of financial regulation are; HM Treasury, Bank of England and the Financial Services Authority.
VAR	"Value at Risk", a modelling technique for assessing risk in financial institutions. Measures the upper bound on losses an institution would expect to incur during a given period and for a given confidence level.

Term	Explanation
wholesale funding	paying short term debt by arranging longer term borrowing, as done through inter bank lending.

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