International Corporate Rescue

Published by:
Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

Annual Subscriptions:
Subscription prices 2011 (6 issues)
Print or electronic access:
EUR 695.00 / USD 845.00 / GBP 495.00
VAT will be charged on online subscriptions.
For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 207 014 3061 / +44 (0) 7977 003627 or sales@chasecambria.com

International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

© 2011 Chase Cambria Company (Publishing) Ltd

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, mechanical, photocopying, recording or otherwise, without prior permission of the publishers.

Permission to photocopy must be obtained from the copyright owner. Please apply to:
E-mail: permissions@chasecambria.com
Website: www.chasecambria.com

The information and opinions provided on the contents of the journal was prepared by the author/s and not necessarily represent those of the members of the Editorial Board or of Chase Cambria Company (Publishing) Ltd. Any error or omission is exclusively attributable to the author/s. The content provided is for general purposes only and should neither be considered legal, financial and/or economic advice or opinion nor an offer to sell, or a solicitation of an offer to buy the securities or instruments mentioned or described herein. Neither the Editorial Board nor Chase Cambria Company (Publishing) Ltd are responsible for investment decisions made on the basis of any such published information. The Editorial Board and Chase Cambria Company (Publishing) Ltd specifically disclaims any liability as to information contained in the journal.

Bank Reform in the UK: Part II – Return to the Dark Ages?

Philip Rawlings, Professor of Law, Faculty of Laws, UCL, London, UK

'To undo the integrated approach to risk assessment, would be to return regulation in the UK to the dark ages!' (Sants)[1]

1. The fall of the FSA

The banking crisis played an important part in the General Election of June 2010 with the Labour government claiming it was the consequence of exogenous events and that Gordon Brown had spearheaded the international response, and opposition parties arguing that the government's reputation for economic management was shattered because of the failure both to prevent the crisis and to respond appropriately when it occurred. A victim of the backwash from these debates was the Financial Services Authority (FSA), which was implicated because the crisis occurred under its watch and, perhaps, because it had been a keystone in the fiscal structure introduced after Labour's victory at the 1997 election. It was claimed that transferring bank regulation from the Bank of England to the FSA meant no agency had oversight of the financial system: the Financial Services and Markets Act 2000 had not made this one of the FSA's functions,[2] and, as a result, it concentrated on conduct of business. The tripartite system was meant to resolve such issues by providing a conduit between the FSA, the Bank and the Treasury; but the crisis revealed a failure of coordination between these bodies, characterised by Paul Tucker, from the Bank, as a problem of 'underlap'.[3] The strength of such claims was implicitly acknowledged in the Banking Act 2009, which gave the Bank statutory responsibility for financial stability and established the Financial Stability Committee at the Bank,[4] although the relationship between this role and the FSA's functions was left unclear.

George Osborne, when Shadow Chancellor of the Exchequer, concluded that a complete restructuring of the regulatory system was needed. He proposed that the FSA and the tripartite system be abolished. In their place 'a strong and powerful Bank of England' should be given responsibility – through a Financial Policy Committee – for macro-prudential and micro-prudential regulation. He argued this would 'ensure that monetary policy, financial stability and the regulation of individual institutions are closely coordinated'.[5] The Liberal-Democrat manifesto, on the other hand, did not suggest the abolition of the FSA or the tripartite system, but instead favoured a stronger relationship between the FSA and the Bank through a Council on Financial Stability.[6] The Coalition agreement that followed the 2010 election contained a promise which, although short on detail, resembled the Conservative proposals.[7] Nevertheless, when the FSA's abolition was not immediately announced, rumours circulated that there had been a compromise between the parties which meant it would survive.[8] As it turned out, George Osborne was working on his reforms and, crucially, he was planning how to reassure the City and the international markets that they would not cause uncertainty or weaken banking regulation. A key to this in his view was the conversion of Hector Sants, chief executive of the FSA, from opponent to supporter of reform so that he would stay on through the transition and then take a leading role when regulation returned to the Bank. In addition, Lord Turner, who had been appointed chair of the FSA at the height of the crisis in September 2008 and had conducted a well-received review of the FSA's work, was persuaded to remain in post during the transition.

Notes

1 H. Sants, chief executive of the FSA, 'Intensive supervision: delivering the best outcomes', speech, 9 Nov. 2009: <tinyurl.com/3xl3ywg>.
2 Financial Services and Markets Act 2000, s. 2(2).
3 Quoted by Lord Turner, *The Turner review: a regulatory response to the global banking crisis* (FSA, Mar. 2009), p. 84.
4 S. 238, Banking Act 2009, inserting s. 2A-2C into Banking Act 1998.
5 *From crisis to confidence: plan for sound banking* (Conservative Policy White Paper, July 2009), pp. 3, 4.
6 *Manifesto* (2010) <www.libdems.org.uk/our_manifesto.aspx>.
7 *The Coalition: our programme for government* (June 2010), p. 8 (<www.cabinetoffice.gov.uk/media/409088/pfg_coalition.pdf>).
8 L. Armistead, 'City watchdog FSA to survive in shock coalition compromise', *Daily Telegraph*, 12 May 2010.

In the curious way that such things are often done in a modern parliamentary democracy, Osborne outlined his proposals in a speech to the City at Mansion House in June 2010. It was not until the following day that Mark Hoban, Financial Secretary to the Treasury, rose to make a statement to the House of Commons.[9] Although dramatic in themselves, these statements were very brief and were only fleshed out in a Treasury paper published in July.[10] This is an unusual document. It is a consultation, but the matters on which contributions are invited are shaped by the announcement concerning the key issue of the architecture of regulation, which is firmly fixed. The consultation process will involve two stages.[11] The first is on the issues highlighted by the Treasury in its paper, which is discussed in this article. This will lead to the publication in early 2011 of a further consultation paper, which will include a draft of the proposed bill. It is expected that a bill will be introduced in mid-2011 with enactment by the following year.

In light of some of things said before the election, it comes as a surprise that the ministerial announcements and the Treasury's paper are relatively mild in respect of the FSA. There is some criticism of past failures and, in particular, those highlighted by the collapse of Northern Rock in 2007; but this merely echoes what the FSA had itself acknowledged in the Turner Review.[12] Instead, there is sympathy for the FSA's impossible position and congratulations on the progress it has made in fixing the problems encountered.[13] This is doubtless, in part, because the FSA's morale and authority needs to be maintained during the eighteenth months or so before a new structure can takeover and because its chief executive and many of its staff will play a role in that new structure. The true villain of the piece is identified as the tripartite system, which failed to paper over the cracks:

> 'the financial crisis demonstrated the inadequacies of the tripartite system of financial stability regulation. The fragmented structure, with responsibilities, powers and capabilities split amongst institutions in an ill-defined way, was exposed as unable to address effectively the challenges the regulatory system faced.'[14]

Nevertheless, the proposals sweep away, not only the tripartite system, but also the FSA.

2. Twin peaks

The proposals see the problem as being that no agency had responsibility for taking a systemic overview and that such an overview can only properly be conducted by the central bank. This analysis made the return of the core regulatory functions to the Bank of England inevitable and so beyond discussion. Yet, it does not mean the only solution is the structure put forward in the proposals, which involves a version of 'twin peaks' – an idea developed in the 1990s by, among others, Michael Taylor.[15] He argued that there should be two regulators: one for prudential supervision, concerned with the stability of the system and individual firms, and the other would oversee conduct of business, that is, broadly, the relationship between firms and customers. Taylor argued that splitting the functions meant each would be more likely to receive equal attention. Although the Labour government rejected the idea in 1997, versions were adopted in Australia and the Netherlands, and during the crisis interest in it revived. Sir Andrew Large, who had served as chair of the Securities and Investments Board and deputy governor of the Bank of England, expressed concern that the lessons of the banking crisis might be rapidly forgotten, and that on its own the FSA might struggle to constrain banks from engaging in the sort of risk-taking which had created the problems, particularly if those banks were supported by politicians keen to see economic growth. He argued that the Bank was ideally placed to supervise the financial system by virtue of its independence from political interference, its access to information about the markets, its role as a source of liquidity and the various fiscal tools at its disposal. The FSA, he thought, could be left to deal with conduct-of-business supervision.[16] This, however, left the problem of the relationship between the FSA and the Bank and raised the spectre of some version of the tripartite system. In a paper for the Centre for Policy Studies, Sir Martin Jacomb, who had been an external director of

Notes

9 The Rt Hon George Osborne, MP, 'Speech at the Lord Mayor's dinner for bankers & merchants of the City of London', 16 June 2010: <www.hm-treasury.gov.uk/speech_chx_160610.htm>; *House of Commons Debates*, 17 Jun. 2010, cols. 1056-1065, Mark Hoban MP.

10 *A new approach to financial regulation: judgement, focus and stability*, July 2010, cm 7874.

11 The Treasury select committee is also inquiring into the government's proposals: <tinyurl.com/35sgzo7>.

12 Lord Turner, *The Turner review: a regulatory response to the global banking crisis* (FSA, Mar. 2009).

13 Exemplified by Sants' warning that, 'People should be very frightened of the FSA': H. Sants, 'Delivering intensive supervision and credible deterrence', speech at The Reuters Newsmakers event, 12 Mar. 2009: <tinyurl.com/adzbwu>. See, *House of Commons Debates*, 17 Jun. 2010, cols. 1056, 1060.

14 *A new approach to financial regulation*, n. 10 above, para. 6.1.

15 M. Taylor, *Twin Peaks: A regulatory structure for the new century* (London: Centre for the Study of Financial Innovation, 1995); M. Taylor, *Peak practice: how to reform the UK's regulatory system* (London: Centre for the Study of Financial Innovation, 1996); M. Taylor, *Twin peaks revisited* (London: Centre for the Study of Financial Innovation, 2009).

16 *Financial Times*, 5 Jan. 2009.

© 2011 Chase Cambria Publishing

the Bank, argued that regulation should be returned to the Bank with systemic supervision handed to a committee and the FSA becoming a subsidiary of the Bank with responsibility for conduct of business.[17]

In the end, the Treasury adopted a form of twin peaks similar to Jacomb's proposal, comprising the Prudential Regulation Authority (PRA), which will be a subsidiary of the Bank and act as the prudential regulator, and the Consumer Protection and Markets Authority (CPMA),[18] which, like the FSA, will be a company limited by guarantee and which will supervise conduct of business. In addition, the Financial Policy Committee (FPC) will be established within the Bank and will have oversight of the financial system.[19] This structure will be informally put into place ahead of legislation through reorganisation of the FSA, which, with guidance from the Bank, will contain the forerunners of the PRA and the CPMA, and through the establishment of the FPC at the Bank. The Treasury hopes to achieve two main objectives by creating this new structure. The first is to restore the connection between, on the one hand, the central banking and financial stability functions of the Bank, and, on the other hand, the regulation of financial services and markets, while maintaining the primacy of systemic issues. The second is to address the tensions between systemic, prudential and conduct of business supervision.

3. The new regulators

The FPC will not strictly be part of the regulatory structure, instead it will have a strategic role to address macro-prudential issues, although in performing its functions it will be able to direct the two regulators: so, for instance, the PRA will be 'the key implementer of macro-prudential policy'.[20] The FPC's objective is to protect financial stability: 'improving the resilience of the financial system by identifying and addressing aggregate risks and vulnerabilities' and 'enhancing macroeconomic stability by addressing imbalances through the financial system, e.g. by damping the credit cycle',[21] while taking into account the effect of its decisions on, in particular, lending to business and families and the competitiveness of UK banks in relation to foreign banks. As part of this role it will monitor the impact of actions by other regulators. If the FPC identifies an issue that requires action, it will have a number of options: it can use one of the tools at its disposal; it can direct the PRA and the CPMA or make recommendations to the Bank, such as addressing a perceived lack of liquidity; and it can recommend changes in the regulatory system to the Treasury. The precise nature of the tools available to the FPC are under consideration, but might include: countercyclical capital requirements by which banks would be obliged to hold additional capital during an upswing in the economy to help them absorb losses in any downturn and to dampen lending; overall limits on the amount of leverage a bank could hold; forward-looking loss provision to oblige banks to hold greater reserves to cover future losses.

The FPC will comprise: six executives from the Bank, including the Governor and the Deputy Governors for monetary policy and financial stability and two executives responsible for these areas, which will facilitate interaction with the Monetary Policy Committee and the PRA; the chief executive of the CPMA, so that systemic issues arising from the work of that body can be identified by the FPC; and four other members from outside the Bank drawn from across the financial sector. There will also be a non-voting representative from the Treasury who will act as a conduit for government's economic policy.

The Treasury lays great emphasis on the need for transparency and accountability in the new system. To this end, the FPC will publish minutes of its meetings and a six-monthly Financial Stability Report (FSR) summing up its assessment of the financial sector, the risks identified and the reasons for any action taken. As a committee of the Bank, it will be accountable to the Court of Directors. In addition, the Governor will meet the Chancellor following each FSR to discuss issues raised by the FPC and the PRA, and edited minutes of these meetings will be published. The Treasury will lay the FSR before Parliament and the FPC's work will be covered by the Bank's annual report, which is also laid before Parliament. The Treasury Select Committee will, doubtless, hold hearings on the FPC, as it already does on the Monetary Policy Committee.

The primary objective of the PRA is to use its regulatory powers 'to promote the stable and prudent operation of the financial system through the effective regulation of financial firms, in a way which minimises the disruption caused by any firms which do fail.'[22] Like the FSA, the PRA will be required to have regard to a range of factors and to act proportionately, but in the

Notes

17 Sir Martin Jacomb, *Re-empower the Bank of England* (London: Centre for Policy Studies, 2009).
18 This is referred to as a working title, but in the way of such things it is likely to stick.
19 See *A new approach to financial regulation*, n. 10 above, chap. 2 (FPC), chap. 3 (PRA) and chap. 4 and 5 (CPMA). There will also be consultation on the creation of an Economic Crime Agency.
20 *Ibid.*, para. 3.10.
21 *Ibid.*, para. 2.24.
22 *Ibid.*, para. 3.5.

© 2011 Chase Cambria Publishing

event of conflict its primary objective will prevail. The PRA will be responsible for the authorisation and supervision of deposit-takers, broker-dealers (investment banks), insurers and associated activities. It will make rules and have the power to take enforcement action, although the Treasury proposes to tackle the slow and burdensome nature of rule making under the Financial Services and Markets Act 2000 (FSMA), and to simplify the rules built up by the FSA. But the FSA has also been attacked for being too light-touch in its regulation and encouraging mere box ticking:

> 'In the run up to the financial crisis, financial supervision relied too much on 'tick-box' compliance with rules and directives at the expense of proper in-depth and strategic risk analysis. Effective prudential regulation of firms requires an approach based on understanding of their business models, and the ability to make judgements about the risks that firms' activities pose to themselves and to the wider financial system as a whole.'[23]

There need not be a conflict in that the rules may be complex and fail to achieve a safe system, but there is a danger in adopting a methodology which might be open to different interpretations.

The Treasury paper discusses the principles of good regulation that currently apply to the FSA,[24] and, in particular, the government seems likely to remove the obligation to consider 'the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom' on the ground that it led the FSA to adopt its light-touch approach to regulation in order to encourage innovation without understanding the new financial products that were being permitted. This still leaves the question of whether the PRA should be obliged to consider the objective of improving competition between banks, which was given such emphasis by the Future of Banking Commission (FBC).[25]

The PRA will be a subsidiary of the Bank. This is designed to give the Bank direct access to an important source of information required for its oversight of the financial system. It is also meant to enable the regulator to 'benefit from the Bank's judgement-driven culture',[26] and 'from the expertise, experience and credibility of the central bank.'[27] It will, however, be necessary to ensure that the connection with the Bank feeds down through both institutions and does not merely consist of shared executive board members. But that connection also needs to be balanced, so a majority of the PRA's board's membership will be non-executives appointed by the Treasury to ensure effective oversight of its operation and 'a constructive and independent challenge to rule-making'.[28] Decision-making on supervision will be delegated to the executive members of the board, or, at least, to a committee in which they form the majority. The Bank will be accountable to the Court of the Bank for the PRA in respect of administrative issues and through the presence of Bank executives on the board. In addition, the PRA will publish an annual report, which the Treasury will lay before Parliament, and there will be some sort of accountability mechanism with respect to its legislative power, which will, presumably, be less burdensome than that applied to the FSA. The PRA will be subject to audit by the National Audit Office, which will allow further public and parliamentary scrutiny through the Public Accounts Committee, and the practice of FSA representatives giving evidence to the Treasury Select Committee will doubtless continue in respect of PRA officials.

The CPMA will be a company limited by guarantee and so formally independent of the government and the Bank. It will be governed by a board with a majority of non-executive members appointed by the Treasury and the Department of Business, Innovation and Skills,[29] although an executive committee will take supervisory action. Accountability will be achieved by the publication of an annual report, which will be laid before Parliament by the Treasury; audit by the National Audit Office, which will bring the CPMA before the Public Accounts Committee; appearances of officials before the Treasury Select Committee; the holding of annual public meetings; consultative consumer and practitioner panels established under FSMA and the Small Business Practitioner Panel, which will be put onto a statutory footing; mechanisms allowing complaints and appeals to be brought against the CPMA;[30] and provision for inquiries into its activities.[31]

The establishment of the CPMA as a separate organisation from the PRA and the Bank is intended to ensure focus on consumer issues without the inclination to compromise macro- and micro-prudential supervision.

Notes

23 *Ibid.*, para. 1.7.
24 Financial Services and Markets Act 2000, s. 2.
25 Discussed in part I of this article. In July 2010, the Treasury Select Committee announced its own inquiry into competition in the banking industry: <tinyurl.com/37wsgtz>.
26 *A new approach to financial regulation*, n. 10 above, para. 3.29.
27 *Ibid.*, para. 3.34.
28 *Ibid.*
29 BIS's involvement arises from its responsibility for consumer and business matters.
30 Similar to that established under FSMA, sch. 1, para. 7.
31 FSMA, ss. 12, 14.

© 2011 Chase Cambria Publishing

But, while this separation may hide conflicts, ultimately it cannot avoid the need to have a mechanism to negotiate them, and, in the end, systemic issues will take priority. It is intended that the CPMA will pick up what the post-Turner FSA started by providing 'a tougher, more proactive and more focused approach to regulating conduct'.[32] Its primary objective is to ensure 'confidence in financial services and markets, with particular focus on protecting consumers and ensuring market integrity.'[33] This will be balanced by the need to take into account certain issues when carrying out its functions, which fall into three categories: the objectives of other regulators, such as the impact of decisions by the CPMA on financial stability, which will require coordination with the PRA and FPC; principles of good regulation, similar to those that apply to the FSA under section 2 of FSMA; and matters of public interest, such as the impact on lending, the promotion of public understanding of the financial system and the need to facilitate competition and access to suitable services.

All financial firms (whether or not they are regulated by the PRA) and dealings in wholesale markets will come under the CPMA. It will regulate conduct that affects, not just ordinary consumers and investors, but also those so-called sophisticated corporate investors, who broadly fell outside the FSA's jurisdiction, since the credit crisis demonstrated how far reaching the consequences of their errors could be. The CPMA will have powers to make conduct-of-business rules and prudential rules that will apply to firms not regulated by the PRA; it will grant permission for non-PRA regulated activities; it will supervise firms and individuals and enforce compliance in respect of the activities it regulates; and it will carry out certain administrative functions, such as collecting levies on behalf of the regulatory system. The CPMA will also take responsibility for the Financial Ombudsman Service, the Consumer Financial Education Board and the Financial Services Compensation Scheme, although the role of the latter means its closest working connection is likely to be with the PRA. In addition, the government is planning to consult on the regulation of consumer finance, which is, at present, split between the FSA and the Office of Fair Trading, with the intention of transferring it to the CPMA.

The other part of the CPMA's role will be to lead on conduct regulation in the wholesale financial markets and in representing the UK in the new European Securities and Markets Authority, which was established following the recommendations of the Larosière committee.[34] However, the systemic importance of the settlement systems and central counterparty clearing houses means their regulation will be undertaken by the Bank, which will also continue to have responsibility for payment systems. The government is considering establishing a regulator of companies within the BIS (Department for Business, Innovation and Skills) to whom it would transfer the FSA's role as the UK Listing Authority and the functions of the Financial Reporting Council. The aim would be to bring together all issues relating to companies, but this may mean losing sight of the distinctive nature of financial firms and markets and the importance of maintaining a clear sight of their activities. Moreover, the separation between the new regulator and the CPMA might recreate the problems of communication and coordination that arose under the tripartite system.

The Treasury paper recognises the importance of a robust framework in the management of any future systemic crisis. The Bank will be responsible for planning the response and carrying it into effect; but the implementation of any plan will need the cooperation of the Treasury because of the Chancellor's control over expenditure and accountability to Parliament for the Bank and because of the political implications of crisis management. Of course, one purpose of the meeting between the Governor and the Chancellor after the publication of the Financial Stability Report by the FSC is to provide an opportunity to warn about, and to discuss, potential problems.

The expectation is that firms will take responsibility for their own crisis management. This was implicit in the FSA's frequent pre-crisis declarations that firms would be allowed to fail, but recent events have demonstrated that such statements do not come true by dint of mere repetition: there has to be planning. This will include an obligation on firms to draw up recovery and resolution plans under rules made by the PRA, which will either bring the firm back to health or effect an orderly winding down. The government contemplates increasing the actions currently available to the FSA under the own-initiative-variation-of-permission powers, including new points at which the power to intervene by the regulator can be triggered and obliging intervention once a threshold has been reached. There is a potential conflict arising from the special resolution regime (SSR), which was established by the Banking Act 2009, between the Bank's role as the lead resolution authority and its responsibility through the PRA for the process of putting a firm into the SSR. The proposal for dealing with this involves contingency planning and resolutions being handled by the Deputy Governor for financial stability and the SSR falling within the

Notes

32 *A new approach to financial regulation*, n. 10 above, para. 4.4.

33 *Ibid.*, para. 4.6.

34 *The High-Level Group on Financial Supervision in the EU* (Larosière committee, Brussels, Feb. 2009) <tinyurl.com/c9bsze>.

© 2011 Chase Cambria Publishing

jurisdiction of the chief executive of the PRA, that is, the Deputy Governor for prudential regulation.

4. Will the new system work?

Apportioning different regulators to deal with prudential regulation and conduct of business does mean that proper attention will be paid to both, but there is a danger that those matters dealt with outside the Bank by the CPMA will be regarded as subsidiary, while the PRA will be empowered by its connection to the Bank. Moreover, separation of issues into different agencies may affect efficiency in that it will mean more communications and monitoring. This will presumably increase the cost of regulation, which will be borne by the regulated firms and, therefore, by their customers. There may also be jurisdictional disputes, overlaps, miscommunication and competition between the agencies, which will not be cured simply by sharing board members, but which will require the creation of a culture of cooperation, coordination and consultation throughout the agencies and the Bank. Yet, cooperation will be hard to achieve because it is in the nature of organisations to compete and to fail to recognise issues that have significance for other organisations.

The proposals do not distinguish between the issue of whether it was wise to detach the Bank of England from regulation and the efficiencies offered by a unified system. While the reforms may not signal a return to the chaos of the mechanisms established by the Financial Services Act 1986, the Building Societies Act 1987, the Banking Acts 1979-87 and the Insurance Companies Act 1982, the creation of three agencies responsible for regulation suggests that, in spite of the opprobrium heaped upon the tripartite system, it must be replaced. The problem may not be particularly pressing during 'normal' times, but it is during a crisis that a lack of clarity may emerge and cause difficulties over the roles of, and the relationships between, the agencies, the Bank and the Treasury, even if the latter has the last say.[35]

Reconnecting monetary policy with regulation may make a good deal of sense; but it has been done with little thought about how effective the Bank might be as a regulator. Certainly, its recent history has been chequered. It only acquired statutory powers over bank regulation in 1979, but over the next two decades it was subject to censure by internal reviews, select committees and judicial inquiries over the handling of Johnson Matthey, BCCI and Barings: so, for instance, Sir Thomas Bingham said in relation to BCCI that the Bank 'tended to lose sight of their primary duty to protect the bank's UK depositors. I do not think that in this instance the Bank measured up to the task.'[36] More recently, there has been criticism of its handling of Northern Rock and the Governor's apparent about face over the issue of pumping funds into the banking system, following pressure from, among others, the FSA.[37] Between 1997 and 2007 the Bank seemed to lose focus on the issue of financial stability, in part, because of its role in monetary policy and, in part, because, while recognising that asset prices and credit were spiralling upwards, the Bank took the view that the market would correct these problems. Eventually, the Banking Act 2009 made financial stability a statutory objective of the Bank. Nevertheless, while the FSA, the government and the banks were being castigated, the Bank emerged from the crisis, not merely unscathed, but with its reputation intact and its power enhanced.

Finally, placing hopes in a new structure invites disappointment since there is no solid evidence that any particular regulatory structure succeeded in either preventing or dealing with the crisis better than any other. Of those countries that operated a version of twin peaks, Canada and Australia emerged reasonably well from the crisis, but the Netherlands did not. Moreover, while bank regulation in the first two countries was in the hands of an independent agency, in the Netherlands it was undertaken within the central bank.[38]

5. The Independent Commission on Banking

Alongside the proposals for regulatory reform, the Chancellor announced the establishment of the Independent Commission on Banking chaired by Sir John Vickers. The commission began its meetings in July 2010, producing an issues paper in September 2010,[39] which will be followed in Spring 2011 by a detailed analysis of the main reform options. The final report will be presented to the Cabinet Committee on Banking in September 2011.[40] Although independent, the government's influence is felt through setting the terms

Notes

35 *House of Commons Debates*, 17 Jun. 2010, col. 1060; *A new approach to financial regulation*, n. 10 above, chap. 6.

36 The Right Hon. Lord Justice Bingham, *Enquiry into the supervision of The Bank of Credit and Commerce International*, 22 Oct. 1992. See, S. Fay, *Portrait of an old lady; turmoil at the Bank of England* (Penguin, 1988); N. Kochan and B. Whittington, *Bankrupt: the BCCI fraud* (Gollancz, 1991); Treasury Committee, *First report: Barings Bank and international regulation*, HC 65, Session 1996/97.

37 P. Aldrick, 'BoE in dramatic u-turn on lending crisis', *Daily Telegraph*, 19 Sep. 2007.

38 *The Turner review: A regulatory response to the global banking crisis*, Mar. 2009, p. 91.

39 Independent Commission on Banking, *Issues paper – call for evidence* (Sept. 2010) <tinyurl.com/2wcqnhp>.

40 The Cabinet Committee is chaired by the Chancellor with Dr Vince Cable as Deputy Chair: 'Sir John Vickers to chair the Independent Commission on Banking' (2010) <hm-treasury.gov.uk/press_11_10.htm>.

© 2011 Chase Cambria Publishing

of the inquiry, the selection of the commission and, ultimately, the decision on whether to implement its recommendations. Aside from Sir John Vickers, an academic and one-time Chief Economist at the Bank, its members are Clare Spottiswoode, who was a member of the FBC, Martin Taylor, who has had various senior roles in business, including chief executive of Barclays, Bill Winters, who was at JPMorgan, and Martin Wolf, a leading financial journalist.

The commission's inquiry will cover many of the concerns raised by the FBC:[41] reducing systemic risk by looking at the risk posed by banks of different size, scale and function; mitigating moral hazard; reducing the likelihood and impact of bank failure; promoting competition to ensure customers' needs are efficiently served; and addressing the competitive advantage of those banks perceived to be too big to fail. In its deliberations, the IBC is required to have regard to 'the Government's wider goals of financial stability and creating an efficient, open, robust and diverse banking sector', and, in particular, the impact of its recommendations on financial stability, lending, the pace of economic recovery, consumer choice, competitiveness of the UK economy, and risks to the fiscal position of the government.[42]

The commission identifies certain topics and within each it highlights a number of questions for discussion. The first topic involves the promotion of stability and competition: what is the relationship between these issues, are they in harmony and, if not, how can tensions between them be alleviated, and what weight should be given to other objectives (lending, the pace of economic recovery, competitiveness and risks to the government's revenues)? The commission suggests that a key risk to stability is that the failure of one firm will cause the financial system to fail because of the interconnections between firms. The crisis has made the FSA's view that no bank is too big to fail – the no zero-fail regime – unsustainable,[43] but the IBC acknowledges that it may not be possible or even desirable to avoid having such banks. Like the FBC, the IBC points out the advantages these banks enjoy over those that are not systemically important and how their presence makes it more difficult for new entrants to the market, which inhibits competition. Moreover, the losses arising from such banks are met by the state, but any profits go to employees in the form of high pay and bonuses and to shareholders in dividends. This creates moral hazard – the incentive to take high risks because the risk-taker does not bear the consequences of their behaviour. The commission also notes that a handful of firms dominate the banking markets for personal accounts, mortgage lending and lending to SMEs and that competition is also limited among investment banks. Yet, the commission reflects a more sophisticated view than the FBC by pointing out that competition may undermine stability by reducing profitability and so encourage higher risk-taking, or it may diminish the incentive to sink resources into monitoring credit risk because of the likelihood that borrowers will move to other banks.

The second topic focuses on possible structural and non-structural reforms to banks and markets to tackle the problems identified. A simple example of the distinction would be that the objective of reducing the level of risk undertaken by banks might be achieved by government imposing capital and liquidity requirements (non-structural) or by prohibiting certain types of activities, such as proprietary trading or the mixing of retail and investment banking (structural).[44] The IBC recognises the need to guard against the possibility of regulation or prohibition leading to activities shifting into unregulated forms, such as happened with the growth of shadow banking; but it is considering the separation of retail from investment banking,[45] or the creation of a bank structure that would allow such activities to be easily unwound in the event of difficulties without affecting depositors, or the use of living wills and resolution schemes, which would involve planning for a crisis. Other possibilities under consideration include contingent capital, which would, for instance, mean that certain types of debt would convert into equity, and structure-related surcharges, which would increase capital and liquidity requirements for systemically important financial institutions. In relation to markets, like the FBC, the commission has put forward ideas about the reduction of market concentration, for instance, by requiring the regulator to promote competition, by obliging large banks to divest parts of their businesses, and by reform of market infrastructure, such as requiring securities to be traded though a central counterparty rather than over-the-counter, which should reduce exposures by facilitating the netting-off of trades.[46]

Notes

41 Independent Commission on Banking, *Terms of reference* (2010) <tinyurl.com/2uvlclc>.
42 *Ibid.*, para. 3.1.
43 H. Davies (chair of the FSA), 'Rational expectations - what should the market and policyholders expect from insurance regulation?' (Airmic annual lecture, 29 Jan. 2002).
44 This issue, which is discussed in Part I, was expressly raised by the Treasury for consideration by the commission.
45 See Part I.
46 The third topic concerns a cost-benefit assessment of the reforms, including the danger of problems migrating from the banking to the shadow-banking sector.

© 2011 Chase Cambria Publishing

6. The policies of reform

Reform is often as much about furthering a political agenda as it is about deep change. The reaction to the crisis has three main facets: the financial rescue package; the restructuring of the banking sector; and the reordering of rules and regulatory structures. The crisis offered an opportunity to alter the nature of banks by restricting the contractual freedom of banks to pay their employees, to break up large banks, to separate retail from investment banking and to facilitate competition for the benefit of customers. These issues were linked by the FBC, which saw the crisis as justifying change on all fronts; but in so far as governments are seeking to tackle them they are doing so separately. In the USA, the bank lobby mobilised its financial and political muscle to resist the break-up of banks, although the Volcker rule limiting proprietary trading has been implemented.[47] In the UK, while the banks have been able to exercise less direct political influence, they have begun to push back, recognising that government has, perhaps, conceded the continued importance of a strong industry and even the force of the threat that banks may simply pick up their bats and balls and move to Switzerland or South-East Asia.[48]

Since the government's post-election strategy has been to cool criticism of the FSA and instead to indentify the tripartite system as the true villain, its abolition of the FSA can only be explained in terms of politics and the attempt to fix the crisis to the last Labour government by attacking both its economic policy and its reform of the regulatory structure. After all, there is no evidence that another regulatory structure would have performed better, either in preventing the crisis or responding to it, and, in any case, the twin peaks idea and the involvement of the Bank in regulation could have been achieved by moving the FSA into the Bank. Announcing the FSA's abolition removes any doubt that would have existed had the issue been part of the Treasury consultation process; but it creates doubt about the strength of the FSA and its ability to impose itself during the next couple of years, which is worrying when the economy in general and the banking sector in particular remain so fragile.[49]

Notes

47 Even this was modified to allow 3% of Tier 1 capital to invested in private equity and hedge funds.
48 But see Sir John Vickers' response to this issue in the press briefing by the IBC, 24 Sept. 2010: <tinyurl.com/2wcqnhp>.
49 This is certainly the view of the Treasury's Asset Protection Agency, *Annual report and accounts 2009-10 of the Asset Protection Agency*, HC 259 (July 2010), p. 4.

© 2011 Chase Cambria Publishing

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

Alongside its regular features – Editorial, The US Corner, Economists' Outlook and Case Review section – each issue of *International Corporate Rescue* brings superbly authoritative articles on the most pertinent international business issues written by the leading experts in the field.

International Corporate Rescue has been relied on by practitioners and lawyers throughout the world and is designed to help:

- Better understanding of the practical implications of insolvency and business failure – and the risk of operating in certain markets.
- Keeping the reader up to date with relevant developments in international business and trade, legislation, regulation and litigation.
- Identify and assess potential problems and avoid costly mistakes.

Editor-in-Chief: Mark Fennessy, Orrick, Herrington & Sutcliffe (Europe) LLP, London

Scott Atkins, Henry Davies York, Sydney; John Armour, Oxford University, Oxford; Samantha Bewick, KPMG, London; Geoff Carton-Kelly, Baker Tilly, London; Sandie Corbett, Walkers, British Virgin Islands; Stephen Cork, Cork Gully, London; Ronald DeKoven, 3-4 South Square, London; Simon Davies, The Blackstone Group, London; David Dhanoo, Qatar Financial Centre Regulatory Authority, Qatar; Hon. Robert D. Drain, United States Bankruptcy Court, Southern District of New York; Nigel Feetham, Hassans, Gibraltar; Stephen Harris, Ernst & Young, London; Christopher Jarvinen, Hahn & Hessen LLP, New York; Matthew Kersey, Russell McVeagh, Auckland; Joachim Koolmann, J.P. Morgan, London; Ben Larkin, Berwin Leighton Paisner, London; Alain Le Berre, BTG Mesirow Financial Consulting, London; Guy Locke, Walkers, Cayman Islands; Professor John Lowry, UCL, London; Dr Carlos Mack, White & Case, Munich; Lee Manning, Deloitte, London; David Marks Q.C., 3-4 South Square, London; Ian McDonald, Mayer Brown International LLP, London; Riz Mokal, 3-4 South Square, London; Lyndon Norley, Greenberg Traurig Maher LLP, London; Rodrigo Olivares-Caminal, Centre for Financial and Management Studies (SOAS), University of London; Christian Pilkington, White & Case LLP, London; Susan Prevezer Q.C., Quinn Emanuel Urquhart Oliver & Hedges LLP, London; Sandy Purcell, Houlihan Lokey Howard & Zukin, London; Dr Arad Reisberg, UCL, London; Peter Saville, Zolfo Cooper, London; Daniel Schwarzmann, PricewaterhouseCoopers, London; Richard Snowden Q.C., Erskine Chambers, London; Kathleen Stephansen, AIG Asset Management, New York; Dr Shinjiro Takagi, Nomura, Tokyo; Lloyd Tamlyn, 3-4 South Square, London; Stephen Taylor, Alix Partners, London; William Trower Q.C., 3-4 South Square, London; Professor Edward Tyler, Department of Justice, Hong Kong Special Administrative Region Government, Hong Kong; Mahesh Uttamchandani, The World Bank, Washington, DC; Robert van Galen, NautaDutilh, Amsterdam; Miguel Virgós, Uría & Menéndez, Madrid; Dr Haizheng Zhang, Beijing Foreign Studies University, Beijing.

For more information about *International Corporate Rescue*, please visit www.chasecambria.com