

Regulatory Myopia

A response to Financial Services Authority DP09/2

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Foreword

The financial crisis was not a failure of *regulation*, but a failure of *supervision*. Like Members of Parliament in the expenses scandal, the banks did not actually break any rules. And yet both the MPs and the banks were able to behave in ways which would clearly have been judged unacceptable, if only someone had bothered to look closely enough.

Financial institutions were, and remain, completely bound by regulations – from how they deal in securities markets to how quickly they pick up the telephone to their customers. Adding more checklists or employing more regulators would not have prevented the crisis. But this is what the Financial Services Authority (FSA) is now proposing.

This response to those proposals argues that instead, we need better supervision of the risks being run by financial institutions, and the *systemic risk* in the sector as a whole. The FSA is not the right body to do this. Instead of being expanded, the FSA should be scaled back to what it can actually achieve, and more weight given to existing market-restraint structures, such as the Financial Reporting Council, and the Accounting Standards Board, and non-executive directors.

In particular, the Bank of England should have a formal supervision role. Stress testing the solidity of the financial system – which, remarkably, seems to have been no more than an afterthought following the crisis – must of course be a continuing part of that supervision.

Other reforms would help too. Investment banking should be separated from retail banking. Banks deemed too big to fail (though often they have grown so because of government regulation and policy) must have stricter capital ratios. Where banks are bailed out by the government, the directors should be disqualified, as in a bankruptcy. For its part, the FSA should focus on principles rather than rules. It should be directly answerable to Parliament, with proper performance indicators. There should be no new international bank regulator, but better liaison between national regulators.

A few extra rules will not improve the solidity of the financial system, any more than they will improve the probity of MPs. We need new approaches that focus on the big things we want to achieve, not on tick-boxes.

Dr Eamonn Butler
Director, Adam Smith Institute

* This paper has emerged from debate within the Adam Smith Institute's Regulatory Evaluation Group. However, the paper itself represents only the views of its authors and not necessarily the views of other members of the group.

1 Executive Summary

The Turner Review and the FSA's 'Regulatory Response' are in complete agreement – hardly surprising since Lord Turner is Chairman of the FSA – and yet both are completely out of tune with the causes of the financial crisis and the reforms that it makes necessary. The central problem is the FSA's self-obsession and self-justification. The Authority:

- aims to *do everything itself* without recognising what others, e.g. auditors and accounting authorities, can do to improve the market and especially transparency;
- fails to recognise that it is *part of the problem* and that the Bank of England may be part of the solution;
- fails to distinguish between *regulation* (which in the event did not prevent the build-up of the crisis) and *supervision* (which might have done, but was lacking);
- relies on *form-filling* and *technical discussions* that do little to make the financial sector secure, but impose huge time and cost burdens on business, damaging UK competitiveness.

The FSA does not need to be expanded. It needs to be streamlined, and this report explains how. But first we provide some *context* with general concerns, identify the *red herrings* and diagnose the *myopia* of the Authority:

- In terms of *context*, most commentators agree that the crisis resulted from the failures of the *regulators*, not a failure of the regulations themselves. Specifically, it was a failure of *supervision*. **The FSA's failure to recognise the extent to which it was itself responsible for the financial crisis compromises its ability to draw lessons for the future.**

- The FSA reports introduce *red herrings* – such as international responsibilities, hedge funds and offshore funds – that distract readers from the Authority's own responsibility.
- The *myopia* section concerns the FSA's determination to expand and handle financial regulation on its own, while overlooking the other parties involved such as the Financial Reporting Council (FRC), the Accounting Standards Board (ASB), and company directors and auditors.

This paper responds to every question in the FSA's Response Form 09/2 and concludes with ten recommendations which can be summarised as:

1. **Greater transparency.** The transparency of financial companies should be enhanced through strengthened ASB guidelines backed up by FSA follow-up with companies that appear not to comply.
2. **Supervision of substance not detail.** The FSA should raise its sights from demanding form-filling and technical discussions with the firms' compliance specialists and middle management, to greater challenge of the firms' directors, especially non-executive directors (NEDs) – with whom, in the case of the largest companies, they should meet regularly. Unsatisfactory responses from a company could lead to a NED being appointed by the supervisory authority. NEDs who resign prematurely should be interviewed by the FSA as a matter of course.
3. **Credit Rating Agencies.** The analysis of the contribution to the crisis by credit rating agencies in FSA 09/2 is superficial, and should be revisited more thoroughly.

4. **Scope of FSA's authority to be better defined and promulgated.** The FSA should make it clear which firms are inside or outside their 'boundary' by requiring 'FSA approved' on inside firms' communications. In general, public protection would be afforded only to depositors in FSA approved firms. All subsidiaries and branches of foreign companies should be treated as if they were UK incorporated entities.
5. **Separating retail from wholesale.** Retail in this context refers to financial companies dealing with non-specialist consumers and businesses, e.g. high street banks. *Wholesale* refers to investment banking and those dealing with other financial specialists – as in the former Glass-Steagall definitions. We would like to see the equivalent of the US Glass-Steagall Act, namely the division of retail and wholesale businesses into separate corporate entities, reinstated in all the G20 countries. To do so only in the UK may have negative competitive consequences but it should nevertheless be considered.
6. **'Too big to fail'.** To avoid moral hazard, those few firms (perhaps the four largest banks) which are deemed too big to fail should now be identified as such and pay a price for that status with higher required capital ratios, etc. The financial sector, borrowers and investors should be made aware that, for other firms, markets will be allowed to take their course. Where any financial company is rescued by the government, the directors should be treated as for bankruptcy (i.e. they should be disqualified with pro rata loss of bonuses and pension rights), and the responsible regulator treated similarly.
7. **Revised remit for the FSA.** The remit for the FSA should not be expanded as FSA 09/2 suggests, but rather be diminished to the point where it matches the FSA's capabilities. In particular, the government should consider returning the supervision of some or all of the banking system to the Bank of England.
8. **The FSA's governance, objectives and performance assessment.** The FSA, like other regulators, should be answerable to Parliament, and not be a branch of government. Within the revised remit, the FSA's objectives and performance indicators should be developed to answer the question 'How do we know whether the FSA is succeeding?' Performance against these indicators should be published.
9. **Principles-based supervisors.** Most regulators claim to be moving towards principles rather than rules based regulation but then as lawyers and others demand explanation, the system reverts to rules. The issue is not the written word but the culture of the FSA and the mindsets of those engaged in policing and supervision. The FSA needs to employ principles-based supervisors, not rule-followers. In practical terms, this will entail the FSA employing fewer people.
10. **No executive international hierarchy** for the enforcement/ inspection of financial standards, in any format, can ever work because it would conflict with national sovereignty. As a workable alternative we recommend establishing a formalised structure for communication and coordination with the FSA equivalents in each of the G20 countries.

2 Introduction

The Turner Review and the FSA's 'Regulatory Response' are in complete agreement – hardly surprising since Lord Turner is Chairman of the FSA – and yet both are completely out of tune with the causes of the financial crisis and the reforms that it makes necessary. The central problem is the FSA's self-obsession and self-justification. The Authority:

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Most commentators agree that the crisis resulted from the failure of the *regulators*, not a failure of the *regulations* themselves. Specifically, it was a failure of *supervision*. There is only the slightest admission of FSA responsibility:

This failure to spot emerging issues was rooted in the paucity of macro-prudential, systemic and system-wide analysis. (Turner Review, p.87)

In other words, the FSA failed to see the wider picture. And again, the FSA 09/2 questions focus attention on narrow, specific matters rather than on the bigger, more relevant issues. The core of the problem needs to be recognized and these reports, perhaps because of their length, fail to do so. The UK financial crisis was created by decisions and organisations within the UK and not, as has been suggested, by international factors. Other countries had similar experience and the consequent recession is global, but it is wrong to try to dodge the bullet by blaming others. That would make reform ineffective – as does ascribing blame to inadequate regulations rather than inadequate regulators. None of these directors, auditors or regulators have been prosecuted or penalised and most remain in post. The FSA's objectives were confused, but no clarification or performance measures are proposed to address this confusion.

The FSA reports introduce *red herrings*, such as international responsibilities, hedge funds and off-shore funds, which distract the reader from the Authority's responsibility and rely on jargon which further clouds the issue.

The *myopia* section concerns the FSA's apparent determination to expand and handle financial regulation on its own, while overlooking the other parties involved such as the Financial Reporting Council (FRC), the Accounting Standards Board (ASB), and company directors and auditors. This preoccupation with itself will continue to undermine proper supervision of the market, or markets.

After responding to the FSA 09/2 questions, we make our recommendations, which are simpler in detail, implementation and expression than FSA 09/2 but would, we suggest, be more effective. The UK needs a resilient financial system with supervision that provides early warning, and with enough influence to ensure heed is taken.

General Concerns

Every single mutual building society that converted to bank status failed and has been merged or closed. It is alleged that the widespread problems in the banking sector were drawn to the attention of senior FSA management, yet not acted upon. Although the FSA has rejected these claims,¹ they concede that *in the past they failed to focus on lenders' business models or commercial judgments 'with the intensity we do now'*. One such failure (Northern Rock) may be excusable, but to fail every business in an entire sector is not.

In a previous Adam Smith Institute Briefing,² we concluded that the failure was not in the regulations but in the regulators. This conclusion has since been endorsed by Lord Mandelson³ and the IMF.⁴

Many US and UK banks were able to build up massive off-balance-sheet assets (and liabilities) by the use of SIVs and conduits. It was clear to any regulator more concerned with substance than form that (come the crunch) these vehicles would live or die only with parent/originator support, i.e. capital. While the Spanish regulators refused to permit Spanish banks to reduce their capital requirements by use of SIVs, US and British banks were permitted to originate billions of loans that were then parked in these off-balance-sheet SIVs with minimal capital. The Canadian banks also remain in far more robust shape than their American counterparts because the Canadian bank regulator went beyond the minimum international requirements of Basel I.

Similarly, the abuses in the US sub-prime market were well known, yet neither the Federal Reserve nor the SEC took any action. It is disingenuous to suggest that many of the abuses were beyond the regulatory remit of the Fed or SEC given that the commercial banks (Citi, Bank of America, Wells Fargo) and investment banks (Bear Stearns, Goldman, Merrill Lynch) were some of the biggest financial backers of the 'unregulated' mortgage brokers which originated the sub-prime mortgages which were then repackaged and securitised by these backers.

The FSA should have been aware of the wider picture and alert to these factors.

Apart from the reference to 'light touch', which is discussed below, the FSA does not include an analysis of its own performance. How then are we supposed to judge the future performance of the FSA? What would it count as success?

Other general issues include the following six points:

1. In addition to recruiting more people to undertake more (and more detailed) intrusion, the FSA is seeking to move onto territory that the 1997 tripartite arrangements gave the Bank of England – namely, responsibility for the systemic integrity of the financial system. You do not need to legislate (p.112, 5.49) for the Bank of England to talk to the FSA: officials can do that any time. Nor, as Lord Turner proposes, should a new joint committee be created: according to the Treasury, a Tripartite Committee already exists.⁵

As the Northern Rock collapse showed, confusion and complexity only make things worse. Clear systemic responsibility should remain with the Bank of England, with both the Bank and the FSA free to consult each other at any time. Yet according to Treasury insider Sir James Sassoon, 'there was only one meeting of the Tripartite Principals – the Chancellor of the Exchequer, the Governor of the Bank of England and the Chairman of the Financial Services Authority – in the ten years preceding the financial crisis.'⁶ These three chiefs should have been meeting regularly to refine their areas of responsibility, the gaps and overlaps, and challenging each other's performance.

An FSA unable to deliver on its existing brief, or even to account for its performance, should not be rewarded by an increased remit. Rather, it should be diminished in scope to the point where its responsibilities match its capabilities. For example, 'the House of Lords Economic Affairs Committee argued that responsibility for macro-prudential supervision — the setting of general rules and standards governing banks to foster stability — should be given back to the Bank from the FSA. The tripartite arrangements had failed, Lord Vallance, its chairman, said, 'in part because it was not clear who was in charge in a crisis and because not enough attention was paid to macro-prudential supervision'.⁷

¹ Jim Pickard, *FSA rejects whistleblower's claims*, Financial Times, April 17 2009.

² Tim Ambler, *The Financial Crisis: Is regulation cure or cause?* Adam Smith Institute, November 2008.

³ Interview, Channel 4 news, 2 April 2009.

⁴ Ana Carvajal & Jennifer Elliott, *IMF Working Paper WP/07/259: Strengths and Weaknesses in Securities Market Regulation: A Global Analysis*; cited Graham Mather, *Capitalism & Government: Rebuilding after the failures*, European Policy Forum 2009, p.50.

⁵ Patrick Hosking, Financial Editor, *Gordon Brown and Treasury accused on banking crisis*, The Times, June 2, 2009.

⁶ *The Tripartite Review*. Preliminary report for the Shadow Chancellor, March 2009, p.17.

⁷ Patrick Hosking, *Ibid*.

2. Almost all our senior informants for this paper asked to remain anonymous, because the FSA wields so much power over them. And academic research shows that great power creates the illusion of control, leading to poor decision-making.⁸ The many regulators of the past are now consolidated into just one that is jealous of any dissent – and this contributed to the financial crisis. Perhaps counter-intuitively, the FSA would be more effective if it were less powerful.
3. As muddled as the Turner Review now claims the original objectives and responsibilities of the FSA to have been, the proposals in FSA 09/2 are no better, and may represent the moving of goal posts to avoid future culpability. Note, for example, that the FSA is not responsible for the financial system but for maintaining *confidence* in, and public understanding of, the financial system.⁹ In other words it is not there to ensure that the system is worthy of confidence, but to promote confidence however misplaced that may be.
4. The language of the Turner Report and FSA 09/2 is opaque and even inaccurate. For example the word ‘framework’ is used 190 times, frequently in association with ‘prudential’. But where this means anything at all, it is merely a list of possible things to consider, when instead we need a clear plan for action. The language is intended to show that we should trust the FSA but in fact makes it less likely that the target market for this report, namely directors of financial institutions, will read and understand the proposals. Similarly, the use of acronyms is excessive – e.g. who knows the difference between PiT and TTC? As will become clear from our answers to the questions, we agree that some reforms are necessary, but they are relatively few and easy to explain. An abbreviated and simplified text would provoke much better responses. It is not too late to develop one.
5. The word ‘risk’ is used copiously but ambiguously. We understand that the FSA risk model was intended to address threats to the FSA itself as distinct from risks to financial businesses and their stakeholders. It is very questionable whether the FSA should take responsibility for risk management within businesses, and the distinction needs clarification.
6. It is scandalous that so few bank directors have suffered any personal pain when their incompetence has damaged their

customers and the country so much. Furthermore, the idea that banks are too important to fail introduces moral hazard especially when, as in this crisis, most of the directors remain in post following rescue by the taxpayer. If supervision were adequate, we would not need to ask whether banks could be allowed to fail: a prudent supervisor would aim to anticipate problems in good time and act accordingly.

Red Herrings

The report distracts the reader’s attention in many ways. For example:

1. **International focus.** It tries strenuously to focus on the international aspects. The financial crisis certainly began in the US, but it spread to the UK as a result of folly by UK domiciled banks. The key decisions were made in the UK under the noses of the UK regulatory authorities. That had nothing to do with international regulations or regulators or the lack thereof.
2. **‘Light touch’ regulation.** Though the report loads blame onto ‘light touch regulation’, we understand that this term was never used within the senior ranks of the FSA, and that they asked the Government not to use it either, since it was misleading. But a heavier ‘touch’ by more officials will not cure a problem if the FSA continues to ignore the big picture. The questions 8-20 on ‘macro-prudential policy’ do not allay our concerns in this area.
3. **Rules versus principles.** Also misleading is the discussion of ‘rules based’ and ‘principles based’ regulation. The FSA claims the latter but practices the former (see the case study below). We need realistic supervision both of the market as a whole and of businesses within it. The supervisory authority should raise significant concerns as soon as possible so that companies can justify their position or make changes. This is not an issue of rules or principles regulation, but of the FSA’s culture and the character of its supervisors.

⁸ Fast, N., Gruenfeld, D., Sivanathan, N., and Galinsky, A. (2009). *Illusory control: The generative force behind power’s far-reaching effects*. *Psychological Science*, pp.20, 502-508; see also Sivanathan, N., Pillutla, M. M., and Murnighan, J. K. (2008). *Power gained, power lost*. *Organizational Behavior and Human Decision Processes*, pp.105, 135-146.

⁹ FSA website, accessed October 23 2008.

Case Study: Medium Sized Financial Services Company

This is a traditional company located somewhere in the sleepy shires but whose identity is necessarily concealed. It is required to supply between 100 and 200 different FSA returns, some several times a year. In other words, the company supplies somewhere short of 400 returns a year. These returns are acknowledged by the FSA but without any feedback as to whether they show good or bad practice and how they compare with the norms of benchmark firms.

A major 'ARROW' review of the company is conducted by FSA every two years or so. These are less frequent in other companies where risk is perceived as low, and more frequent for those seen as higher risk. Over a one-month period this may involve dozens of meetings, each involving many FSA personnel with one company staff member. The meetings are one-sided in the sense that company managers are educating FSA staff rather than the latter bringing expertise to the table.

The FSA report back after five months, but are very guarded on risk ratings. For example, no peer group is named and identification of what is 'good' is opaque. In other words, the feedback is essentially useless. The FSA levy for this process is calculated according to size and costs up to £1m p.a. for companies such as the one in question.

In total, the cost to the company of financial regulation is well over £5m p.a. This is in addition to the costs of other forms of regulation.

4. **Hedge funds.** Whilst it is true that some hedge fund activity may have contributed to market volatility, counter-trading may also have had the opposite effect. Hedge funds operating in the UK and their managers based in the UK have always been regulated by the FSA, and further regulation, both UK and offshore, was considered in 2002.¹⁰ Hedge funds in the US are not regulated by the SEC or other authorities. However, hedge funds were not a significant factor in the banking crisis and it is misleading to present them as such. Furthermore, we doubt the legal and operational ability of the FSA to regulate non-UK financial businesses.

6. **Tax havens.** Similar comments apply: these did not contribute to the banking crisis in any meaningful way, and discussion of them simply distracts attention from the important issues at hand.

Myopia

The FSA has created its own world of technical checks, but ignores the restraints that already exist in the real world. Directors run their businesses, auditors audit them and the Financial Reporting Council (FRC) and Accounting Standards Board (ASB), provide standards for reporting. The FSA asks no questions about how best to fit in with, or make best use of, this existing structure. Apart from one mention of liaising closely with directors, auditors and the FRC about greater 'granularity' in banks' accounts (Box 5.1), there is no mention of the FRC or ASB at all.¹¹

There are only seven other mentions of auditors. Paragraph 11.10 says, *inter alia*, 'it remains essential to recognise that firms' senior management carry primary responsibility for their actions and their resulting consequences. This responsibility is also shared with non-executive directors (NEDs), shareholders and auditors. The FSA believes strongly that a key element of successful regulation is to work in partnership with these groups.' But this is the only such expression in 214 pages.

The overall impression gained by the reader is one in which the FSA is operating in its own world, reinventing its own wheel when plenty of other useful wheels already exist. That is a major shortcoming when, for example, we learn that the FSA did internally foresee the collapse of Northern Rock and the consequent effects on HBOS, but then failed to take any effective action.¹²

Some of the details of the new proposals may well improve the inspection of financial businesses, but without a far more radical reform of the FSA itself, and its attitudes, that will be like giving spectacles to someone who cannot see.

¹⁰ Michael Folger, the FSA's Director of Conduct of Business Standards, said on August 21 2002: "Although hedge funds are usually incorporated and governed in offshore jurisdictions, mainly for tax reasons, many employ fund managers onshore. The UK-based fund managers providing services to hedge funds are legally required to seek authorisation from the FSA. Our powers under the Financial Services and Markets Act cover the activities of such a firm and the services it has contracted to provide its clients." <http://www.fsa.gov.uk/Pages/Library/Communication/PR/2002/086.shtml>

¹¹ Except that the ASB is noted as appearing in the Recommendations and Implementation table (pp.200-202), even though it does not do so.

¹² Catherine Boyle, The Times, May 30 2009: "Secret 'war games' were held by the Financial Services Authority (FSA), the Bank of England and the Treasury, all of which have been criticised for not spotting weaknesses in Northern Rock's business model earlier, showed that the lender was at risk and that its troubles would have a domino effect on HBOS. This belies assertions from the Government that no one could have predicted the collapse of Northern Rock, which is now owned by the state, in late 2007."

3 Our responses to the FSA's questions

The questions below are reproduced verbatim from the FSA website.

Section 3

Q1 – Are there shortcomings in the international prudential framework not already identified in the DP that are relevant to the analysis?

As noted above, 'prudential framework' is a meaningless expression and adding the word 'international' merely diverts attention away from UK failures. The section identifies a list of technical deficiencies and we are not able to add to that list. But they are symptoms not causes. Main causes include firms' failure to think through the consequences of the good times not continuing; failure to understand the complex instruments their firms were buying; and failure by the FSA to supervise effectively.

Q2 – What are the measures supervisors should take to mitigate the risks to depositors and other unsecured senior creditors of secured funding, taking account of the benefits of such funding where used to an appropriate degree?

See our ten recommendations at the conclusion of this paper.

Section 4

Q3 – Do you agree with the proposals to redefine the definition of capital with a stronger emphasis on going concern loss absorbency?

The proposals are too vague to agree or disagree with, e.g. 'The FSA would propose that any new definition of capital should be used to meet all types of risk, including market risk.' (4.8, p.88).

Q4 – Should IRB banks be required to use a system such as variable scalars, or equivalent, whose effect is to limit the potential for procyclicality in capital requirements to a level

that would be produced by a TTC ratings system?

'Variable scalars' is meaningless jargon and careful reading of the exposition (Box 4.1, p.89) leaves one no wiser. Arithmetic is being applied to concepts which cannot be arithmetically computed in the hope of making them appear scientific. On the other hand, requiring directors to report verbally and numerically on their approach to cyclical factors and what economic cycle reserves are being made or withdrawn (see pp.109-110) seems perfectly sensible and could be implemented through appropriate revision of the ASB reporting guidelines. See Recommendation 1 at the conclusion of this paper.

Q5 – Are there any other key issues that the review of trading book capital should cover?

Firms should be required to distinguish their trading and proprietary books and satisfy the supervisory authority of that adequate liquidity exists for themselves and for the market. UK subsidiaries of multinational groups should be treated as if they were stand-alone UK companies.

Q6 – How should the leverage ratio capture (i) off-balance sheet exposures and (ii) derivatives?

We have two situations here: off-balance-sheets assets and exposures which are reported through notes to the accounts or in the narrative sections, and those which are not reported at all. In the latter case, reporting guidelines (see our Recommendation 1), should make it best practice formally either to report that no significant off-balance sheet assets or exposures exist, or to report what they are. Transparency is the key. This would, of course, be subject to audit. In the former case, users of the reports, including the FSA, should be able to calculate the ratios, with and without the off-balance sheet items, for themselves if they wish to do so. If the information is insufficient, they can ask for more.

Q7 – Should the numerator of the leverage ratio be Core Tier 1 capital or should a broader measure of capital be used?

That is like asking if a tool should be a spanner or a screwdriver. The appropriate tool depends on the purpose for which it is intended. The only requirement here is that there should be sufficient reporting transparency (see our Recommendation 1) in either usage.

Section 5

Q8 – Should these reforms be applied to smaller and domestic banks, building societies and investment firms? If so, how can this be achieved in a proportionate manner?

As proposed in Recommendation 4, the FSA should be explicit about which firms fall within the FSA's boundary and so should the firms themselves. Below a certain size, the costs and benefits to the firms and to the FSA do not justify being subject to compulsory FSA supervision. Smaller firms might conceivably benefit from FSA regulation – it may be attractive to clients – but such regulation should, ideally, be a matter of mutual consent.

Q9 – Do you agree with the FSA's reasons for favouring a range of policy measures to deal with macro-prudential policy issues rather than adjusting the Basel II risk-based capital requirement?

In this question, the FSA seems to be devising new management tools while ignoring what the directors are already doing. Some firms may adopt the revised Basel II approach and others may not. Both may be right in the context of their businesses. The FSA should not attempt to impose blanket rules on disparate businesses, but instead look at what the directors are looking at. If that makes sense, the FSA should let directors get on with it; if not, the FSA should discuss alternatives with the directors. If all else fails, there are fines and expulsion from the FSA's protection zone.

Q10 – What should be the focus of the FSA's initiatives on valuation and disclosure in UK banks' accounts so as to maximise their impact on market confidence?

As the last response implies, the FSA should avoid sweeping new initiatives, but look at what directors are actually doing and satisfy themselves of the sense of that.

Q11 – Do you agree with the FSA's analysis of the implications of accounting standards for procyclicality?

Up to a point, but it is too theoretical, and it is unlikely to be practical in all cases. The FSA should discuss the issues with the FRC/ASB and agree any resulting revision of reporting guidelines (see Recommendation 1 below). Solutions are more likely to be found in transparent narrative reporting than in the formal accounts.

Q12 – How best should prudential regulators address the problem of procyclicality through counter-cyclical reserves/buffers?

This suggestion opens the door to manipulation of the accounts. Liabilities and provisions should be treated according to existing rules. Creating [secret] reserves or buffers may begin with the best of counter-cyclical intentions but they would rapidly become piggy banks which would allow directors to present whatever bottom line they care to create. Transparency is, once again, the answer: directors should address risk in the narrative section of annual reports and are free to comment on cyclicity and what notional allowance should be made to offset current highs or protect against future lows – or vice versa. The possibility that any bank deemed too 'large to fail' should have to maintain higher capital adequacy ratios and liquidity than other financial businesses should be considered. Transparency would be achieved by the publication of the conditions for these 'category 1' banks who would publish that status. To some extent banks would be free to opt in or out of this category but those opting out would clearly lose the implied national guarantee. Market competitiveness might be enhanced as these requirements would offset the economies of scale.

Q13 – Do you agree that serious consideration needs to be given to establishing some form of global supervisory architecture for international audit firms?

No, although we share the concern that auditors do not appear to have made any positive contribution to financial stability. Whether or not one sees the Big 4 audit firms as a cosy club at national level, the global level is unlikely to be different. One finds the same players, many of the same clients and the same outcome – i.e. the audited banks have stacked up losses on an unprecedented scale as reflected in the April 2009 IMF Global Financial Stability Report, detailing global indebtedness linked to the financial crisis. The EU competition authorities might wish to consider breaking up this potential cartel but that is not a matter for the FSA. Nor would it be an easy thing to do. Also outside the FSA's remit is whether auditors should be nominated at AGMs and a vote taken by shareholders, or whether an audit committee comprised of shareholders should undertake this role, thereby adding an element of independence. We have not made that a recommendation since it is not a matter for the FSA to determine.

Q14 – What macro-prudential policy tools should be considered other than those mentioned in this DP?

If 'macro-prudential policy' refers to the financial stability of the whole system, then that should be left to the Bank of England, calling on the FSA as the Bank determines. In addition, the FSA should draw any macro concerns they may have to the Bank's attention.

Q15 – What are your views on the effectiveness of a core-funding ratio as a measure to constrain excessive asset growth?

Neither a ratio nor any other metric will constrain growth: the question should be whether it is a metric to which management will ascribe meaning, relevance and importance. That in turn will depend on its context, and the competence of the management. The FSA is free to draw any metric they consider relevant to the attention of management and they do not need a regulation to do so.

Q16 – What types of institutions should be exempt from such a core funding ratio? How would any exemptions limit the effectiveness of the measure?

This question represents a misuse of language. How can an institution be 'exempted' from a metric? See previous response.

Q17 – To what extent would market discipline and the convergence of supervisory practices be improved by the disclosure of information relating to Pillar 2 assessment? What information would be most useful?

Useful to whom and in what circumstances? This is an ill-conceived question that can provoke no sensible response. We agree that the FSA should confer with FRC/ASB about disclosure in general.

Section 6

Q18 – Are there other considerations that are relevant to the assessment of the issues and risks posed by the boundary question?

We agree that the boundary question is an important matter for clarification and have made recommendations below.

Q19 – Is the escalating response set out here the right way to deal with the threats to financial stability and consumer protection posed by unregulated financial activities and institutions? Or should the FSA, along with other regulators, develop an alternative approach?

This is another question that diverts attention from the failures of regulators. With the exception of credit rating agencies and the boundary issue confusions, there is no evidence that hedge funds, tax havens or other, relatively minor, sectors made any contribution to the financial crisis. It is also worth pointing out that hedge funds operating in the UK are all regulated by the FSA whereas previously hedge funds based in the US were unregulated. Risky activities (6.25, p.129) are not the same as risky firms, and these risky activities were largely conducted by regulated firms and hedge funds. However, not all hedge funds pursue high-risk, high-reward strategies. One of the characteristics of the hedge fund marketplace is the diversity of risk-reward appetites. The irony is that the problems arose from the regulated and the regulators, not the unregulated.

Q20 – What are the implications of subjecting parent holding companies for financial services groups to direct powers to comply with the requirements of the prudential framework?

We agree (see recommendations below) that where groups require approval for their UK branches or subsidiaries, the FSA should be entitled to look also at the financial probity and resilience group-wide. That said, we could not find 'the requirements of the prudential framework' specified in the report.

Section 7

Q21 – Are there other issues which regulators should take into account when assessing their response to the evidence from the current crisis that some financial institutions have been deemed too big to fail fully? If so, what are they?

Identifying, ex ante, institutions deemed too big to fail creates moral hazard and should be avoided so far as possible. We have to accept however that major firms such as the four largest banks will come into that category whatever anyone says. We recommend higher safety margins, e.g. capital ratios, for any companies so identified and greater penalties (e.g. loss of pension rights and recovery of bonuses) for the directors of failed companies that were rescued because they were, ex post, deemed too big to fail. In effect, these companies were bankrupt and the directors should be treated accordingly, i.e. disqualified with pro rata reduction in bonuses and pension rights. Similarly, the supervisory authority would also have failed and the key regulator should be penalised accordingly.

Q22 – What are your views on the balance between varying the intensity of supervision according to the impact and risk that an individual firm poses, and having policy frameworks and approaches that differentiate across-the-board according to a firm's systemic significance?

This question is too imprecise to be of any real value. Of course the intensity of supervision should depend on the characteristics of the firm and its market context and the potential risks for the firm and the larger market, i.e. the systemic significance and risks. We are not impressed by 'policy frameworks' whether they are the firm's or the FSA's; realistic supervision should be the key.

Section 8

Q23 – Are there other aspects of group structures that the FSA should be taking into account?

We consider multinational group structures to be of only marginal interest for the FSA as it lacks the ability and authority to look beyond the UK shoreline. It should focus on UK businesses (incorporated or otherwise) as well as any foreign-owned entities operating in the UK. On the other hand the domestic UK group structures should be of interest to the FSA and especially the issue of whether retail (consumer-facing) and wholesale (e.g.

investment banking) businesses should be completely separated or simply report separately. See our Recommendation 4.

Q24 – Is the increased focus on group structures and intra-group relationships and increased supervisory cooperation the right way to deal with the threats to financial stability and consumer protection posed by large, international group structures? In what circumstances would a greater focus on individual legal entities be warranted?

Supervision should take place primarily at the level of UK firms, be they subsidiaries, branches or supposedly independent entities where non-UK entities have dominant interests, and whether they are incorporated or not (see Recommendation 4). Any available information on non-UK constituents of those groups should be taken into account but that is likely to be partial and legal entities outside the UK do not fall within the FSA's jurisdiction. If they hide behind that, the FSA is entitled to refuse recognition to the UK entity.

Section 9

Q25 – How can the international architecture be arranged to provide the most effective early warning of threats to financial stability and challenge to national authorities and in an apolitical way?

An executive global structure able to direct national supervision is infeasible as it would conflict with national sovereignty (see our Recommendation 10). We are therefore looking for forms of liaison between the FSA and its equivalent bodies in the main financial markets. The G20 would, in our view, be the most appropriate set of countries; but that should not prevent the FSA liaising elsewhere when circumstances so require. The FSA is free to challenge other countries' regulators and should accept challenge in return.

It is fallacious to believe that multinational companies must be regulated multinationally. They are all headquartered in one country or another and their subsidiaries in each country should be treated as a stand-alone business in that territory, i.e. they must be locally viable.

Q26 – Is this the most effective way of organising colleges on the one hand and crisis management groups on the other?

This is overly complex and bureaucratic. The 'college' (merely a collective noun for the FSA-equivalents in, say, the G20) would be free to create such subcommittees to deal with such situations as arise. Since compulsion would not be feasible, agreement would be needed.

Q27 – Do these options represent the right approach to the problems posed by EEA branching?

In our view, whether countries are part of the EEA or EU is largely irrelevant. If the UK were to accept the EU as a level of authority

in these matters, then there would logically just be one seat at the higher level college for the EU, or EEA, as a whole. The single market concept of the EU, while not yet a reality, should encourage some degree of best practice standardisation and harmony for the FSA-equivalents in the EU and thereby strengthen their collective position in the global college. However, no separate 'architecture' is required.

Q28 – Are the functions of rule-making capability and supervisory oversight the right ones to be given to a European institution that has the characteristics described here?

No – for the reasons given above.

Section 10

Q29 – Does the DP highlight the correct issues concerning the role of CRAs and the use of their ratings?

The tables in this section provide a substantial, if perhaps surprising, endorsement of the credit ratings business. The default rates (Table 10.1, p.163) are presumably based on the defaults after the downgrades took place and may therefore be misleading. A large part of the problem is that downgrades took place long after they should have done and arguably were put in place just in time to save the face of the agencies. The FSA argues that Credit Rating Agency (CRA) resources should be shifted from initial ratings to monitoring whether they are justified subsequently. It is not clear how CRAs are supposed to do that. How will they have access, worldwide, to confidential information within all firms, not just financial firms, on a daily basis? To what extent do downgrades actually bring defaults about and thereby increase instability? The analysis in this section seems superficial and inadequate – see Recommendation 3. Further public debate is required to analyse the barriers to entry in the credit rating agencies market and what might be done to encourage a more open, competitive market which participants can rely on. The lack of new entrants into this market and the over reliance on just three rating agencies is a serious cause of concern.

Q30 – Are the approaches outlined to address these issues appropriate and proportionate?

No – see above.

Q31 – What options should a review of the use of structured finance ratings in the regulatory framework consider?

See above.

Q32 – Is this the most appropriate framework for post-trade transparency or are there other aspects we should be considering?

As noted elsewhere, we support greater transparency in reporting and look to the FSA to suggest practical reporting options to the FRC/ASB. The 'framework' presented here (p.174) can be

criticised for being another vague wish-list. The statement, 'Any trade transparency regime should also be delivered in a cost-effective way, without unintended adverse consequences' is so obvious as to be trite. Rather than try to predict the unpredictable consequences of action, these European workstreams would be better employed in comparing the modus operandi of each member state's FSA and developing a model of best practice. See Recommendation 10.

Q33 – Are there other measures which the FSA should be considering or promoting in international fora?

See above and our concluding Recommendation 10.

Q34 – What other considerations should the FSA take into account with respect to OTC derivatives infrastructure?

None apart from those noted elsewhere in this response.

Q35 – Are any (other) changes to clearing arrangements needed? If so, what should they be?

As part of making markets more transparent and, indeed, more effective as market places, the FSA should encourage more standardisation of clearing and settlement arrangements and conditions. But this is a matter of encouragement, not regulation

Q36 – Are any changes to settlement arrangements needed? If so, what should they be?

See answer to Q35.

Section 13

Q37 – Which of the issues set out for discussion in this DP are most relevant to other regulated sectors?

The issues of transparency in reporting apply, substantively, to all quoted companies and we agree they should be extended to hedge funds. Clarification of boundaries is also a general issue.

Q38 – Are there any lessons which have been learned in other sectors which could be applied to banking?

The level, complexity and detail of regulation in financial services have all shifted from too little to too much. Consumer protection in other sectors is primarily provided by branding and the recognition by directors of the importance and value of their brands. The FSA has sought to replace that with legalistic and expensive intervention which adds to costs and reduces competition. We have not witnessed a failure of markets but a failure of financial management and regulation. The FSA persists in defining failures in terms of regulations as distinct from failures by the regulators. We support transparency as a way of making regulation work better, but simply adding more regulation will not solve any problems. Instead, the FSA should consider how to use market forces better, notably brands, and use regulation less. A start could be made by reducing the size and complexity of the FSA itself.

4 Policy recommendations

- 1. Greater transparency.** The transparency of financial companies should be enhanced through strengthened ASB guidelines backed up by FSA follow-up for companies that appear not to comply. The only specific FSA proposal was for improved granularity for large financial groups, and we agree with that. The FSA should discuss with FRC/ASB how the guidelines might be improved. Although making the guidelines mandatory has been discussed, the consensus is that it would not be practical. Perhaps as a result, conformity with the guidelines is patchy at best.
 - 2. Supervision of substance not detail.** The FSA should raise its sights from demanding form-filling and technical discussions with the firms' compliance specialists and middle management, to greater challenge of the firms' directors, especially non-executive directors (NEDs) – with whom, in the case of the largest companies, they should meet regularly. Unsatisfactory responses from a company could lead to a NED being appointed by the supervisory authority. NEDs who prematurely resign should be interviewed by the FSA as a matter of course.

Again, the focus must be on supervision rather than form-filling. Directors' failure to understand the complex instruments being purchased, or to test the validity of their business models, or to see the potential repercussions of one set of activities on other parts of the bank, all contributed to the present crisis.
 - 3. Credit Rating Agencies.** The analysis of the contribution to the crisis by credit rating agencies in FSA 09/2 is superficial, and should be revisited more thoroughly. Allegations that ratings were driven by the fees received from the rated businesses are too serious to gloss over. The FSA should publish, on an early warning basis but after private discussion with the agencies, all such concerns.
 - 4. Scope of FSA's authority to be better defined and promulgated.** The FSA should make it clear which firms are inside or outside their 'boundary' by requiring 'FSA approved' on the inside firms' communications. In general, public protection would be afforded only to depositors in FSA approved firms. The FSA's ability to expel a firm would be a more potent threat than a fine. This would address the complications of international groups. Where a group seeks approval for its UK subsidiary or branch, it would need to meet the FSA's requirements both at the level of the UK subsidiary and group-wide.
 - 5. Separating 'retail' from 'wholesale'.** 'Retail' in this context refers to financial companies dealing with non-specialist consumers and businesses, e.g. high street banks, whereas 'wholesale' refers to investment banking and those dealing with other financial specialists – as in the former Glass-Steagall definitions. We would like to see the equivalent of the US Glass-Steagall Act, namely the division of retail and wholesale businesses into separate corporate entities, reinstated in all the G20 countries. To do so only in the UK may have negative competitive consequences but it should nevertheless be considered.
 - 6. 'Too big to fail'.** To avoid moral hazard, those few firms, perhaps the four largest banks, which are deemed too big to fail should now be identified as such and pay a price for that with higher required capital ratios, etc. The financial sector, borrowers and investors should be made aware that, for other firms, markets will be allowed to take their course. If any financial company is rescued by the government, the directors should be treated as for bankruptcy: i.e. they should be disqualified with pro rata loss of bonuses and pension rights and the responsible regulator treated similarly.
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7. **Revised remit for the FSA.** The remit for the FSA should not be expanded as FSA 09/2 suggests, but rather be diminished to the point where it matches the FSA's capabilities. In particular, the government should consider returning the supervision of some or all of the banking system to the Bank of England.
8. **The FSA's governance, objectives and performance assessment.** The FSA, like other regulators, should be answerable to Parliament, and not be a branch of government. Within the revised remit, the FSA's objectives and performance indicators should be developed to answer the question 'how do we know whether the FSA is succeeding?' Performance against these indicators should be published.
9. **Principles-based supervisors.** Most regulators claim to be moving towards principles- rather than rules-based regulation, but then as lawyers and others demand explanation, the system reverts to rules. The issue is not the written word but the culture of the FSA and the mindsets of those engaged in policing and supervision. The FSA needs to employ principles-based supervisors, not rule-followers. In practical terms, this will entail the FSA employing fewer people.
10. **No executive international hierarchy** for the enforcement/ inspection of financial standards, in any format, is ever going to work because it would conflict with national sovereignty. As a workable alternative we recommend establishing a formalised structure for communication and coordination with the FSA equivalents in each of the G20 countries. The financial crisis has shown the regulators to have been at fault, and not just the UK ones. The FSA should agree with the SEC and other national supervisors that they should take a hard look at their own performance and develop a best practice model for the practice of regulation and supervision. They should also challenge each other when dangers seem to be appearing elsewhere.

Conclusion

The problems that became apparent in the financial crisis will not be resolved by a stricter regulatory environment. Indeed, quite the opposite may be true. More regulation creates the illusion of control, and may even serve to decrease the transparency. What we do need, however, is improved supervision, with regulators engaging with companies on the companies' own understanding of their businesses.

About the authors

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