

THE REGULATION OF FINANCIAL SERVICES

Written evidence for the joint House of Commons/House of Lords Committee on the
Financial Services Bill

T R G Bingham¹

KEY RECOMMENDATIONS

- **Ensure that the arrangements give adequate attention to securing the continuity, depth and efficiency of core financial markets.** In a twin peaks' approach there is a risk that this will fall between two stools. The Financial Conduct Authority is responsible for market conduct regulation, but its focus is consumer protection. The Bank of England Group will pay attention to systemic stability, but does not have an explicit mandate for the systemic integrity of short-term money markets. The risk can be reduced by giving the central bank explicit responsibility for oversight of key short term markets – as in Mexico – or ensuring that the Financial Policy Committee has and uses powers of direction over the market conduct authority and that the Bank has the legal, financial and operational capacity to act as market maker of last resort in critical short-term markets.
- **Make sure that the Bank of England has the financial capacity to perform its financial stability functions.** The crisis demonstrated the potential risks to central bank balance sheets. The Bank needs adequate resources to perform its financial stability functions, and clear procedures are needed to provide it with continued financial integrity.
- **Clarify responsibilities for crisis management.** At present, the proposals contain a placeholder – a call for a memorandum of understanding between the Treasury and the Bank. Responsibilities, decision making procedures and triggers for activating them need to be specified in a manner that permits rapid action and clear accountability.
- **Ensure the FPC and/or the Bank has a legal right to be consulted on legislation relating to financial stability and to obtain all information needed to discharge its duties.** In the EU, there is a statutory obligation to consult the ECB about legislation on matters in its field of competence. The Bank of England should be consulted on such legislation in the UK. In addition, it needs the statutory right to obtain information that is material to the discharge of its functions.

¹ Secretary General, Central Bank Governance Forum (2005-2011). The views expressed do not necessarily reflect those of any of the institutions, bodies or fora with which I am or have been associated.

- **Strengthen the proposed accountability arrangements for the Bank.** Oversight of policy decisions by Parliament and its committees, effective reviews of processes and operational capacity by a professional and impartial Court, and double-key decision making procedures (including giving the Treasury secondary legislation powers subject to Parliament override) are needed to make a more powerful institution more accountable. The Bank should be shielded from influence by vested interests, irrespective of whether they are political or commercial.
- **Recast the proposals so that the legislation is simpler and clearer and permits flexibility.** The proposals as presented to Parliament are lengthy, complex and lacking in logical order. Some fairly minor matters are addressed in great detail in primary legislation, while others of potentially great significance for financial stability are not addressed at all. The primary legislation should set out the broad objectives and the basic structure of regulatory arrangements; secondary legislation should give effect to primary legislation and oversight bodies should have clear authority to establish bylaws, rules of procedure and codes of conduct.

INTRODUCTION

This note responds to the request for comment by the joint Committee conducting pre-legislative scrutiny of the draft Financial Services Bill. It addresses the issues of interest to the Committee thematically, instead of replying to the 22 questions posed by the Committee. In so doing it provides implicit or explicit answers to some, though not all of the questions. The note draws on an extensive body of evidence covering more than 50 central banks published by the BIS.²

OVERALL ASSESSMENT

The proposals being considered by Parliament provide a practicable framework for preventing, managing and resolving financial crises.³ They allocate responsibility with more clarity than in many other countries.⁴ They establish a well-articulated framework for macroprudential policy at a time when few countries have such a framework. They provide an effective means for setting objectives in the financial stability area, where objectives are - unlike in the monetary policy arena - not amenable to quantification.⁵ They introduce checks and balances into the regulatory system, and they supplement the already strong accountability arrangements for the Bank of England with new ones. Nonetheless there are a few areas where improvements merit consideration.

One of the lessons of the financial crisis of 2007 to 2009 is the importance of focusing on the stability of the financial system as a whole. There is, however, no consensus in the international community on just what this means in practice.⁶ At one end of the spectrum, there is the view that it suffices to use prudential instruments and other administrative measures. In the middle is the view that such tools need to be accompanied with changes in the way monetary and fiscal policies are conducted. At the far end of the spectrum is the view that these two approaches need to be supplemented by significant changes in the structure and operation of the financial system.

In part because there is no consensus on what needs to be done, there is no consensus on how the responsibility for the function should be allocated across public authorities. Each

² See *Central Bank Governance and Financial Stability* and *Issues in Central Bank Governance*. Both reports can be found at <http://www.bis.org/publ/other.htm>.

³ These proposals were prepared at the same time that serious reflection about the structure of the financial services industry in the United Kingdom was undertaken by the Vickers Commission. This could lead to changes in legislation governing the financial industry and the regulatory framework. The implications of these changes for the design of financial regulation are not taken into account in this note.

⁴ There is primacy for the financial stability objective in the proposals, together with suitable "have regards" relating to the promotion of efficiency and fostering competition in the financial services industry. One of the consultation questions was whether it would be reasonable to limit the FPC's actions if they were to affect growth. Given the "have regards" in the proposals, this does not seem necessary. Indeed, it is possible to turn the question on its head and to argue that the FPC should be **required** to consider taking action if the growth of the financial sector were too fast or if it threatened to become "Icelandic" in size – "too big to save".

⁵ The proposed language is "*An objective of the Bank shall be to protect and enhance the stability of the financial system of the United Kingdom*". Since events elsewhere could affect financial stability in the United Kingdom, the Bank could be said to have an implicit mandate to cooperate with authorities abroad. However, there are circumstances where the current language could create an impediment to international cooperation. It could also be contrary to requirements set out by the Financial Stability Board that call on authorities to consider the potential impact of action on financial stability in other jurisdictions (see FSB Recommendations on reducing the moral hazard posed by systemically important financial institutions, October 2010; FSB consultation document on effective resolution framework for financial institutions, July 2011.

⁶ See *Central Bank Governance and Financial Stability* op. cit.

jurisdiction takes an approach suitable for its institutional, political and historical circumstances. At least two common features can be identified in the approaches that have been adopted. One is that the central bank plays an important, although varying, role. The second is that the government is responsible for the use of taxpayers' money to salvage financial institutions and the financial industry.

The proposals being considered by the Committee deal with the ambiguity about the nature of the systemic stability function. They allot the Bank an important, but constrained role, while ensuring that the government is responsible for the use of taxpayers' funds. The financial stability objective of the Bank of England is broad; reasonable procedures have been put in place to flesh it out, and the powers given to the Bank and the FPC are general enough to accommodate different interpretations of the financial stability mandate.

However, there are six issues that merit reconsideration. The first relates to the risk that the proposed arrangements will not ensure the stability of critical short term markets essential for the provision of liquidity. The second relates to specification of responsibilities in a crisis. The third to the financial capacity of the Bank of England to perform its financial stability functions. The fourth concerns the powers needed to perform a financial stability function. The fifth one relates to accountability and ensuring the effective performance of the financial stability function. There is a final question about whether the proposed legislative process is consistent, comprehensive and flexible.

SIX ISSUES

Risks arising from the use of a "twin peaks" approach

One of the weaknesses of the "twin peaks" approach is the risk that inadequate attention will be given to securing the continuity, depth and efficiency of core financial markets. This is a serious shortcoming because both the Lehman episode and the current European debt crisis demonstrated that the repo, commercial paper and other short-term funding markets can become dysfunctional in periods of stress. According to the proposals, the FCA will have primary responsibility for regulating these markets. Its focus is, however, primarily on the prevention of market abuse, and consumer protection more generally. The language in the proposal cites market integrity as one of its responsibilities, but this term admits of a variety of interpretations. The one most likely to be adopted by an authority focused on consumer protection is in terms of deterring fraudulent activity and other types of behaviour that cast doubt on the integrity of the transactions that take place in the market. An authority with a systemic stability mandate such as the Bank of England will be inclined to view market integrity from a systemic perspective and seek to ensure the continuity, depth and liquidity of the market in all circumstances.

There are at least two potential solutions to this problem. One is to give the central bank oversight of key markets in which liquidity is managed. Such markets are critical for the implementation of monetary policy. Mexico is an example of a country that has adopted such an approach.

A second approach is to allocate responsibility for market oversight to the market conduct authorities, but give the FPC an explicit mandate to monitor the continuity, depth and liquidity of key short-term markets and to use its powers of direction to ensure that the FCA takes systemic considerations into account. Alternatively, the FCA could be given an explicit mandate to do so. The problem with this is that it risks conflating the systemic and consumer protection objectives, which is one of the main reasons for segregating market conduct regulation from prudential regulation.

In addition, the Bank of England needs the legal and financial capacity to act as market maker of last resort in core short-term money markets.

Financial strength of the Bank of England

There is one important area where the proposals are silent. This is how to ensure that the Bank of England has the financial strength to perform its policy functions, especially when they include financial stability. As a consequence of the crisis, the size and risk characteristics of the balance sheets of many central banks, including the Bank of England, have increased massively.

The proposals are clear that the Chancellor should be in charge when taxpayers' money is put at risk. This is consistent with the approaches applied in other countries, as well as with general principles relating the use of fiscal resources. The Bank will have the independent authority to provide liquidity to the financial system. This is appropriate but it can expose the Bank to financial risk.

Around the world there are three main ways central banks are given the financial strength they need to perform their policy functions. The one used in the United Kingdom is to rely on strong collateralisation procedures and to provide the central bank with indemnification for the losses it could incur in performing financial stability operations. This was the approach used in the crisis, and it permitted the central bank to undertake substantial financial stability operations. A second approach is to ensure that the central bank has sufficient capital. This is the approach used in many European countries such as the Netherlands, Sweden, and Switzerland. It has also been adopted by the ECB. A third approach is to give the central bank a prior claim on seigniorage⁷ income to make good financial shortfalls encountered in its operations even if it has no or little capital. As long as seigniorage income is sufficient, such an arrangement will permit the central bank to make up losses incurred in its operations without impairing its capacity to perform its policy tasks. This is the approach followed in the United States as well as a large number of other countries.

Given the increase in financial risk, it is appropriate to consider how to provide the Bank of England with the financial strength it needs. Any of the three methods – or some combination of them - could be envisaged. The one most compatible with the traditions of central banking in the United Kingdom is to establish robust “double key” procedures for financial indemnification of losses incurred in the conduct of policy. The Bank should not be constrained by inadequate financial strength from acting decisively and quickly. At the same time, it is important that the central bank be shielded from pressure to undertake tasks that are the responsibility of the government.

At present, Court must approve operations that put the Bank's balance sheet at risk. As long as Court is properly constituted and has an explicit mandate to safeguard the central bank's capacity to perform its statutory responsibilities (see below), such arrangements provide an effective check on the use of the central bank for quasi-fiscal ends.

Allocation of responsibility and decision making in a crisis

The proposed framework provides for a broad allocation of responsibility in a crisis, with the Treasury responsible for decisions relating to the use of taxpayers' money, and the Bank responsible for providing emergency liquidity assistance and operating the special resolution

⁷ Historically, seigniorage was the difference between the face value of a coin and the cost of the metal used to mint it. Over time it has come to refer to the revenue that arises from the issuance of money (banknotes). Economically, it can be considered the discounted present value to the income on assets funded with monetary liabilities issued by the central bank.

regime.⁸ The Governor will be required to update the Chancellor on financial stability matters semi-annually and to notify the Chancellor whenever there is a risk to public funds.⁹

This allocation of responsibility is based on the distinction between liquidity and solvency. While this distinction is useful conceptually, it is difficult to apply in practice, particularly in a crisis. In such circumstances institutions that are solvent one day – and therefore eligible for liquidity support – can become insolvent overnight. In fact in the crisis, the institutions that failed were on average slightly better capitalised at the time they first received official assistance than other institutions, but this did not prevent them from requiring public funds to survive.

The proposals call for a memorandum of understanding between the Bank and the Treasury. Procedurally this is adequate, but crafting such a memorandum should be a high priority. The memorandum should specify the procedures that will be used to make decisions in a crisis. In particular they should set out credible and effective procedures for making decisions on the use of taxpayers' money in a manner that preserves the Bank's policy capacity both in the crisis and in "peace time". In addition the memorandum should indicate the criteria to be applied in determining when crisis management procedures will be activated. The draft should be reviewed by Parliament and Court (see above and below regarding the role of Court).

Bank of England's powers

By and large, the Bank of England Group will have adequate powers to perform its financial stability functions. Moreover, the Treasury will be able to use secondary legislation to amend the FPC's toolkit immediately, subject to approval by Parliament within 28 days. However, there are two areas where the Bank of England's proposed powers are deficient. First the Bank does not have the statutory right to obtain the information it needs to perform its financial stability function. It is difficult to see how the FPC can carry out its objective of identifying, monitoring and taking action to remove or reduce systemic risks without assured access to relevant information. Central banks in other countries have such powers, even when they are not supervisors. For example in Sweden the central bank, which is not responsible for bank supervision, has the legal right to obtain the information it needs in the discharge of its duties. It has found it necessary on occasion to invoke this right.

Secondly, there should be a statutory provision to ensure that the Bank is consulted on legislation that has the potential to influence financial stability. The EC Treaty gives the ECB, as part of the European System of Central Banks, such a right and the ECB has used it actively.¹⁰ In the EC this right is "double edged": lawmakers at both the EU level and national level have an obligation to consult the ECB on matters in its field of competence, and the ECB has the right to issue opinions on its own initiative on these matters.¹¹ Creating such rights and obligations with respect to the Bank of England would be an effective way to address the risks posed by the shadow banking system, since the Bank could, in addition to

⁸ The SRR gives the Bank powers needed for the resolution of a UK based financial institution. How such powers would be used in a cross border question has not been addressed in the legislation. (*Question 13*)

⁹ The draft is unclear about what this means in practice. It could mean that the central bank would need to inform the Chancellor whenever there was a risk that the government's tax revenue would need to be used to provide solvency support. It could mean that the Governor should inform the Chancellor whenever there is a risk that the central bank would incur a loss since the government is the owner of the Bank of England and its equity stake in the Bank can be considered to be "public funds", i.e. an asset of the government.

¹⁰ See <http://www.ecb.int/pub/pdf/scplps/ecblwp9.pdf> Article 105(4) states ECB shall be consulted on draft legislation, either at the Community level ("EU consultations") or at the national level ("national consultations"), in its fields of competence.

¹¹ NB There is a carve-out for the UK in the EC Treaty with respect to this provision.

using its current powers of direction, suggest legislative changes to address such risks (*Question 10*).

Autonomy and accountability and the role of Court¹²

There is as yet no widely accepted consensus on the amount and nature of the autonomy needed by a public policy institution with a mandate to foster financial stability or on how the corresponding accountability mechanisms should be designed. In some respects the need for autonomy is greater in this area than in the area of monetary policy because financial stability decisions are inherently more political. At the same, it is more difficult to provide autonomy because financial stability actions require collaboration with governments, other regulatory authorities and competition authorities.

The proposals contain effective means to hold a more powerful Bank to account. Current arrangements already provide for strong accountability, particularly in view of the fact that the Bank of England's scope for independent decision making is more limited than that of many other central banks.¹³ The Bank's transparency practices with respect to monetary policy are among the strongest in the world. Regular and ad hoc reviews by Parliament of the Bank's actions are undertaken in a manner that probes the rationale for the policy decisions. In the operation of the interim FPC, the Bank has demonstrated similar forms of transparency.

The proposals provide for additional reviews in the event of a regulatory failure. Moreover, the Chancellor will retain the power to give instructions to the central bank in areas other than monetary policy. And the Court of Directors will be able to exercise oversight of process and the stewardship of resources.

Review is an important complement to transparency in the field of financial stability. This is because financial stability objectives cannot be given the same quantifiable precision as monetary policy ones. Reviews of performance are generally conducted or commissioned by parliamentary committees, government ministries, oversight boards, external auditors, international organisations and panels of experts. By and large, parliamentary committees and government ministries are responsible for the review of policies, whereas oversight boards are responsible for establishing procedures, monitoring processes and overseeing the use of resources. The two forms of review are complementary.¹⁴

The role of Court

Court should have a well-defined role in ensuring the Bank is accountable and independent. It should review the Bank's performance on behalf of the ultimate beneficiaries - the public at large. At the same time, it should have a statutory duty to shield the bank from pressure from vested interests, irrespective of whether they are commercial, financial or political. Its oversight should cover the effectiveness and efficiency of the Bank in the performance of its public policy objectives. In performing this role, it needs to be independent, impartial and professional. It should evaluate the processes the Bank uses to make decisions, the actions to implement these decisions and the use of resources needed to perform public policy functions.

¹² Cross country evidence on accountability arrangements for central banks can be found in written and oral evidence presented to the House of Commons Treasury Committee (see <http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/uc874-iv/uc87401.htm>) .-

¹³ For example, many central banks such as the ECB and the Fed have the discretion to determine what their statutory mandates mean. By contrast, in the United Kingdom the Chancellor performs this task by setting an inflation target for the central bank.

¹⁴ Legal provisions are often framed to ensure that the board oversight will be complementary to that of Parliament and government, for example, by excluding members of Parliament and government from central bank boards, as in France, Ireland, Sweden, the United States and a number of other countries.

The specific functions performed by oversight boards vary from central bank to central bank, but they can be placed in four clusters. The first involves establishing bylaws, rules of procedure and codes of conduct, and allocating tasks across management. The second cluster is financial and involves approving budgets, determining accounting policies, deciding on risk management practices, determining the retention or distribution of profits and safeguarding the financial integrity of the institution. The third consists of audit, compliance and other actions to ensure observance of laws, secondary legislation and rules established by the board itself. The final cluster consists of personnel actions, including the appointment and dismissal of senior officials. Court should have a clearly specified role in all four areas, with double key decision making being used to forestall the abuse of power and to provide for checks and balances.

For example, primary legislation could set out the functions of the FPC and the PRA Board, determine their maximum and minimum size, itemise the qualifications of the members (professional expertise, independence) and specify a small number of ex officio members, to be appointed in the manner suggested in the proposals. Within the clear limits set by primary legislation, secondary legislation could be used to determine the precise composition of the committees (e.g., whether insiders or outsiders were in a majority), using a double key method involving the Treasury and Court. The proposals for changes would be made by Court in light of its evaluation of process. For example, if it determined that there was a risk of groupthink, it could propose changing the balance between insiders and outsiders. By contrast, if it felt that greater cross-committee coordination was needed, it could decide that there should be more cross membership. In deciding on rules of procedure, it could call for occasional or regular joint meetings of the policy committees.

Similarly in overseeing the financial integrity of the Bank, Court would need to approve operations that put the balance sheet at risk and make sure that appropriate risk mitigation, indemnification and/or capacity to absorb losses were in place. In short, Court would be responsible for overseeing the Bank's capacity to perform its public policy functions. It would not, however, evaluate the appropriateness of policy. This task would fall to Parliament.

In order for Court to perform these tasks, considerable attention would need to be given to the professional qualifications of the members, their independence and their impartiality. They would need expertise in the four clusters of responsibility, and knowledge of the public policy function of central banks. They would be selected in the manner now used, which is open and transparent.

Consistency in the legislative framework

The proposals being considered by the committee foresee a fundamental change in the way financial services are regulated in the United Kingdom. However, instead of starting from first principles, they take existing practices, institutions and legislation as a point of departure. This results in legislation that is far longer and complex than in other countries. As a result a number of minor institutional details are fixed in primary legislation (such as the frequency of meetings of the FPC) rather than being determined in secondary legislation or rules of procedure. In most countries, a legislative reform of this significance would lead to a framework where primary legislation would set out the primary purposes, structures and powers; secondary legislation would give them greater precision, and bylaws and similar instruments would be used to determine procedures and processes. For example, rather than specifying the exact nature of the consultation process in primary legislation, the purpose of consultation could be laid down, with the modalities for consultation being set out in secondary legislation and the procedures being determined by Court.

It would be useful to review the proposals to see whether some adjustments could be made that would make the framework more logically consistent and to provide for needed flexibility in the future. If this can be achieved, it will not be necessary to reform legislation so frequently.¹⁵

¹⁵ The last legislative reform in this area took place just two years ago, in 2009.