Financial regulation in united kingdom

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Introduction

What policy-maker should do to improve the system of financial regulation to achieve its objectives more effectively becomes a hot topic especially after the financial crisis 2008. More and more people begin to pay attention to financial regulation. According to a survey from FSA in 2009, the spontaneous awareness of financial regulation amongst people living in Great Britain aged 16 was 21% and it is the highest level since the survey began[1].

This essay will analyse financial regulation in United Kingdom into three perspectives; the first part will explain how the system of financial regulation operates in the United Kingdom. Then, the reasons why financial services industry should be supervised by regulation such as FSA, and new challenges in this system in response to the financial crisis 2008 will be discussed in second part, final part will be some problems with the current system in my point of view to better protect the economy and consumer.

The financial regulation system in United Kingdom

First of all, a brief review of the history in the late 20th century of financial regulation system in United Kingdom may be necessary and useful to establish a better background and deeper understanding. London's financial district is known as " The City" for many years, until the end of 1970s there was no specific banking law in the UK, however, prompted by the secondary banking crisis in 1972, the Banking Act 1979 was promulgated and assigned formal responsibility for supervision of the UK banks (Heffernan 2007)[2]. " The evolution of the UK's financial sector since the early 1980s can be thought of as the gradual confluence of three previously quite separate

streams. These are the ‘ primary’ banking sector, monitored and supervised by the Bank of England; the organized markets in the City, and the rest of the financial sector, including building societies and insurance companies and licensed securities dealers, each of these steams exhibited significant differences in the style and nature of regulation, especially in the balance between statutory and self-regulation”(Blair)[3]. As the consequence of the Stock Exchange’s Big Bang, which means a series of financial reforms to encourage greater competition, the aim of Financial Services Act (1986) was to protect investors. One year after, the Bank Act 1987 was amended to the Banking Act 1979, this Act established a new Board of Bank Supervision, which assists the Bank of England in regulating other banks.

The closure of BCCI (1991) and the bankruptcy of Barings (1995) exposed the problems of the supervisory abilities of the Bank of England and the drawbacks of the self-regulation (Heffernan, 2007)[4]. On 20 May 1997, the Chancellor of the Exchequer announced the reform of financial services regulation. In this resolution, banking supervision and investment services regulation were merged into the Securities and Investments Board (SIB), which changed its name to the Financial Services Authority in October 1997. Financial Services and Markets Act 2000 made the FSA became the sole regulator of all United Kingdom financial institutions. Since that time, FSA took the responsibility for all aspects of financial regulation progressively. According to the Financial Services and Markets Act, several other organisations’ responsibilities were transferred to the FSA, such as Building Societies Commission, Friendly Societies Commission, and Investment Management Regulatory Organisation. FSA supervises the financial services

industry as “ an independent non-governmental body, given statutory powers by the Financial Services and Markets Act 2000”; “ We are a company limited by guarantee and financed by the financial services industry. The Treasury appoints the FSA Board, which currently consists of a Chairman, a Chief Executive Officer, two Managing Directors, and ten non-executive directors (including a lead non-executive member, the Deputy Chairman). This Board sets our overall policy, but day-to-day decisions and management of the staff are the responsibility of the Executive”. FSA has four statutory objectives, maintaining confidence in the financial system, promoting public understanding of the financial system, securing the appropriate degree of protection for consumers; and reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime (FSA, 2005)[5].

According to Heffernan (2007)[6], FSA tries to make a balance between risk and competition. RTO (risk to our objectives) approach is used widely to manage the risk in firms that supervised by the FSA (except the telecommunications and utilities sectors, etc), RTO also gives a score of probability of a certain firm to be a target for preventing the FSA from achieving its four statutory objectives. The score is easily calculated through:

Impact score = (impact of the problem) * (probability of the problem arising)

Each firm will be scored from A (very high risk) to D (low risk), and the score will also indicate the strength of supervision that FSA implements in a firm.

Being a member of EU, UK financial regulation is influenced by EU’s regulation in financial service industry, which is Financial Service Action Plan.

An article named The EU Financial Services Action Plan: A Guide[7](2003), which prepared by HM Treasure, the Financial Services Authority and the Bank of England, introduced that UK financial law was effectively determined by the FSAP. It means that any UK financial regulation should not be conflict contradictory, and “ the UK authorities should be keen to ensure that the UK financial sector, corporate sector and consumer groups are consulted on, and fully understand the impact of, FSAP measures.” European Commission uses FSAP to improve EU financial markets to be a Single Market, FSAP aims to fill gaps and eliminate remaining barriers among all EU members. Furthermore, in order to make EU financial services worked more effectively, Lamfalussy process was launched by EU Committee. It is a four-level, regulatory approach for adoption. Trying to consider the relationship between FSA and FSAP, the article also addressed that the FSA not only has extreme influence in UK’s financial services, but also make its own contributions in EU, HM Treasury, the FSA and the Bank play key roles in identifying, influencing, promoting and overseeing the UK’s interests in financial services in the EU. Promoting public understanding of the financial system and ensuring an appropriate degree of protection for consumers are objectives of FSA which also inform in EU.

Why we need financial services industry to be regulated

A brief history of UK financial regulation, which was introduced at the beginning of this article, may be a part of the whole picture. However, there are other extremely important reasons that hastened the coming of a type of financial regulation represented by FSA.

At first, it is still necessary to review an important feature, which is self-regulation, in the development of the FSA. “ Self-regulation has proved to be an effective and reasonably efficient system for the British securities industry until very recently”[8] (Rider). However, just like the historical review that illustrated above, with the upward rising of scandals and the dramatic change in security market, the foundation of the monopoly of self-regulation mechanism was challenged before the emergence of the “ super-regulator”. Although FSA 1986 seemed that make a balance between statutory framework and self-regulation, the financial regulation system was still largely depended on self-regulation. The issue of mis-selling pensions has the most impact to make the government to make the final decision to end the self-regulation. Public confidence was significantly lost in personal pensions at that time and the truth that SIB lack adequate enforcement powers to take regulatory actions precipitated the process of giving financial service industry a statutory regulation system. After FSMA 2000, FSA’s enforcement is safeguarded and the whole financial system in United Kingdom has leaned to be supervised in statutory way rather than self-regulated.

The economic rationale for regulation will be examined as follow. According to an article, “ The Economic Rationale for Financial Regulation”[9], written by David Llewelyn (1999), he analyses several reasons why there is a demand for a systematic regulation in economic world. Firstly, there are potential systemic risks in financial industry especially in banking industry. The main systemic risk is bank run, and worse still; this can leads to a solvent bank becoming insolvent since the limitation of most bank assets to

be marketable, and due to asymmetric information problems, bank assets cannot be sold at par as potential buyers, these will add a high risk premium in the purchase price. Therefore, for the sake of depositors and banking institutions, a type for regulation on the bases of systemic risk is necessary. Secondly, market is not perfectly competitive. The main reason of market imperfection is that not all the investors can get adequate information of a certain market which they are engaging in, and this will impose costs on the consumer. Consequently, regulation plays a significant role to make sure the process of information disclosure and reinforce an effective market environment. In the article, he also explained the economies of scale in monitoring. " Because of the nature of financial contracts between financial firms and their customers there is a need for continuous monitoring of the behaviour of financial firms." Regulatory agencies should monitor the financial firms in the name of consumers, since regulatory agencies are more effective and cost less in monitoring financial firms.

After financial crisis 2008

Almost all of the financial regulation agency aim to maintain the stability of the financial market and consumer's confidence; however, the change of real market circumstance seems faster than policy-makers' precautionary measures.

According to a speech, " The financial crisis and the future of financial regulation"[10] from Adair Turner, the Chairman of the FSA, he explained the main reason why this extreme crisis happened is the interaction between macroeconomic imbalances and the fast development in financial market which happened last ten years. In his speech, since the decline of the real

risk free rates of interest, such as government bonds, credit extension was got a chance of dramatic growth especially in residential industry with deteriorated credit standards. Moreover, a desire to find a substitute for government bonds among investors who want to gain as much as possible spread above the risk-free rate was exploded. Sophisticated investment banks created a new kind of securitized credit instruments and it boomed so quickly, but unfortunately, like Lord Turner said: “ Not all innovation is equally useful”, it collapsed since the investors became irrational. To reduce the adverse impact in economy, rebuild the investor’ confidence and avoid future crisis, he pointed several strategies that regulators may concentrate on improving the regulation system. He argued that financial system should modify originate and distribute model which refer to securitized credit model easier to be understood, and “ more transparent to end investors”. He also suggested that a new regime for capital adequacy and liquidity is necessary to lower the possibility of future crisis. In the end of his speech, he emphasized that financial regulation should always ensure that financial activities are regulated on the basis of their economic substance instead of their legal form. In the Turner Review[11] published by FSA in March 2009, there are more specific approaches about banking supervision that FSA plans to change and introduce. All the recommends can be highly summarized to be seven key measures as follow:

1. Increasing the quantity and quality of bank capital.
2. Significant increases in trading book capital: and the need for fundamental review.
3. Avoiding procyclicality in Basel 2 implementation.

4. Creating counter-cyclical capital buffers.
5. Offsetting procyclicaality in published accounts.
6. A gross leverage ratio backstop.
7. Containing liquidity risks: in individual banks and at the systemic level.

(FSA, 2009)

After the financial crisis happened, FSA has been undertaking massive actions to improve regulation system. For example, according to FSA Annual Report 2008/09[12], the Banking Act 2009 is mainly able to resolve default problem and strengthen financial stability; as a result, a new bank insolvency procedure was introduced. A statement from FSA about Banking Act 2009 from FSA in July 2009 claimed that the Financial Services Compensation Scheme (FSCS) can not only “ pay compensation to eligible customers of a financial firm if that firm – including deposit takers – is unable, or likely to be unable, to pay claims against it” but also “ can also be required to contribute to the costs arising from the actions taken under the SRR.”[13] In addition, FSA increased the general depositor protection limit from £35, 000 to £50, 000 per person per deposit-taking institution which will cover most of retail deposits in October 2008. In the aspect of supervising firm’s capital adequacy, FSA made efforts to let firms which have most impact know essential controls and standards by Dear CEO letter. Closely cooperated with EU and global regulation, FSA played an important role in G20 London Summit in April 2009, which focused on the future priorities for global financial regulation, and Basel Committee on Banking Supervision. Many recommendations, which became detailed international agreements, were from FSA. According to FSA Business Plan 2009/10[14], the FSA will

intensively focus on the competence of Significant Influence Functions (SIF) individuals in high-impact firms. The Plan announced five core improvements that FSA will be focus on, which included an upgraded Training and Competence (T&C) scheme for relationship-management supervisors, a new tenure policy (it will provide a framework for the minimum and maximum time a supervisor should manage a firm).

My view in current UK's financial supervisory system

During the accumulation of the knowledge of the history about the development of UK's financial regulation and the causes of financial crisis 2008, I find it is a process that the financial regulation continuously suits the changeable financial services industry, financial regulation's solutions seem behind a certain innovations in financial market which has already begun cause negative effects in the whole economy. Financial crisis 2008 is evidence to prove that if financial regulation does not detect potential problems in a certain financial innovation and does not make adjustment promptly, a new crisis would be inevitably and it would cost a lot to correct the system along the right track. Therefore, an important lesson from crisis 2008 is financial regulation should always pay close attention to the moving direction of the market and fully analyses a financial innovation. A suggestion in my point of view is that financial regulation may has legislative to investigate and estimate potential risk within a new financial product before it begin it to sell, and this procedure may require close cooperation with related financial institution.

On the other hand, financial crisis 2008 make regulators intensively focus on risk-based analysis especially in banking or like-banking institutions, but it

should not equal to discourage financial innovation. Almost all the financial derivatives contain risk, while, as long as regulators estimate it appropriately, these new financial products that contained huge intelligence can benefit consumers.

Conclusion

Being a single financial regulator in United Kingdom, Financial Services Authority has powers which was given by Financial Services and Market Act (FSMA) to supervise Britain financial industry. Demand for such kind of regulation can be observed in history and economic perspectives. Financial crisis 2008 as a prelude to FSA reinforces its system, supervision in banking industry become more intensively. The crisis also gave regulators a lesson that it is necessary to establish a balance between surpluses and deficits on the global level in the long-term, in addition, prudential analysis should be in a more effective way in order to reduce systematic risk. Finally, not just FSA, but all the other financial regulations should cooperate closely to build a more stable global financial system and avoid future crisis.

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