

FINANCIAL STABILITY ANALYSIS IN THE U.K.

Callum McCarthy

Chairman
Financial Services Authority

There are, of course, many models for financial authorities to be found in various countries round the world. Broadly, there are divisions between countries which separate prudential supervision from conduct of business and those which unite them; and those which separate different financial sectors (normally into banking, securities and insurance) and those which combine two or three of those sectors. The UK stands at one extreme: we have an institution, the Financial Services Authority (the FSA), which combines responsibility for prudential and conduct of business across all three sectors (and indeed beyond). Today, I propose to do two things: first, to describe the institutional arrangements in the UK for promoting and preserving financial stability; and second to consider the ways in which these arrangements have been developed since they were established in 1997.

2. The foundation of the present arrangements was established by two major decisions taken by the then- and now – Chancellor of the Exchequer, Gordon Brown, in taking up office in May 1997, as a new Labour Government came to power. In time sequence, they were first to give responsibility for monetary policy to an independent Bank of England, and second to make one – then yet to be formed – institution, the FSA, responsible for all supervision of banking, insurance and securities activities (as well as of building societies and friendly societies) – a responsibility previously discharged by nine previous organizations, some self-regulating organizations, some parts of central government and one particular important responsibility of bank supervision discharged by the Bank of England.

3. In making these major changes to the institutional landscape, it was important to establish clear responsibilities for how the three institutions – HM Treasury as finance ministry, the Bank of England, and the FSA – would work in future. This was one in October 1997 in a Memorandum of Understanding between HM Treasury, the Bank and the FSA. It was based on four guiding principles:

- Clear accountability. Each institution had to be accountable for its actions, and should therefore have unambiguous and well-defined responsibilities.
- Transparency, so that Parliament, markets and the public knew who was responsible for what.
- No duplication, so as to avoid second guessing, inefficiency and duplication of effort.
- Regular information exchange, so that each institution would be helped to discharge its responsibilities efficiently and effectively.

Although there have been some changes made to the details of the MoU, these principles remain untouched.

4. I will describe the responsibilities of the three institutions, starting with the Bank of England. The MoU stated that the Bank is responsible for “the overall stability of the financial system as a whole”, which involves in particular:

- (i) stability of the monetary system, including day-to-day market operations to deal with liquidity fluctuations;
- (ii) financial system infrastructure, in particular domestic and international payments systems;
- (iii) broad overview of the system as a whole, including advising on the implications for financial stability of developments in domestic or international markets and payments systems;
- (iv) in the exceptional circumstances where official financial operations were necessary, to conduct those operations – ie to be the agent of intervention to prevent systemic risk developing; and

(v) the efficiency and effectiveness of the financial sector, with particular regard to international competitiveness.

5. The responsibilities of the FSA, which were established along with its powers in statute by the Financial Services and Markets Act 2000, as set out in the MoU are four:

- (i) authorizing and supervising banks, building societies, investment firms, insurance companies and friendly societies; in total, the FSA supervises some 29,000 firms, more than 90 per cent of which are small entities. I will return to some of the implications of this later;
- (ii) supervising financial markets and clearing and settlement systems. The FSA is therefore responsible for supervising the London Stock Exchange, the London Metal Exchange, and LCH. Clearnet – among many other exchanges and clearing and settlement systems;
- (iii) conduct of operations in response to problem cases affecting firms, markets and clearing and settlement systems which pose systemic risk, when those operations are different from the market operations which the Bank would carry out. The FSA operations might for example include changing capital or regulatory requirements, or facilitating a market solution;
- (iv) regulatory policy in these areas. The FSA advises on regulatory implications for firms, markets and clearing systems of developments in domestic and international markets.

You will note the close symmetry of two of the sets of responsibilities of the Bank and the FSA. They are very similar concepts, but applied to infrastructure and the payments structure in particular on the one hand, and to firms, markets and clearing and settlement systems on the other.

6. Last, there is HM Treasury, which is responsible for the overall structure of regulation, and the legislation which governs it. But the MoU makes clear that it “has no operational responsibilities for the activities of the FSA and the Bank, and will not be involved in them”. The MoU establishes a number of circumstances where it expects the Treasury to be informed by either the FSA or Bank (for example, when a problem might cause wider

economic disruption, or lead to diplomatic or foreign relations problems), but leaves the decision as to whether to inform the Treasury to the Bank or to the FSA.

7. The MoU has a number of other important aspects. It places explicit responsibilities on both the Bank of England and the FSA to share information, and establishes cross-membership of the Court of the Bank and of the Board of the FSA. I sit on the Court, and the Deputy Governor responsible for financial stability within the Bank, John Gieve, sits on the FSA Board. A representative of the FSA attends the meetings of the Bank's Financial Stability Board, which John Gieve chairs. It also established a Standing Committee of Bank, FSA and Treasury which meets monthly to discuss either significant individual cases or wider developments, and also makes provision for the Standing Committee to meet at short notice. The MoU also provides for the handling of crises by the Bank, FSA and Treasury where it recognizes more clearly than past practice and the locus of the Treasury, which arises from the ultimate responsibility if financial instability has implications for public finances.

8. The changes to the original text, published in March, were basically to bring it up to date by reflecting developments in financial markets and institutional roles. In particular, the Tripartite authorities' frameworks for responding to and managing both financial crises and major operational disruptions had advanced significantly since the original MoU; these improvements were reflected in the new text.

9. It is worth considering how these arrangements measure up, some nine years after the event, against the four guiding principles. I will for understandable reasons, concentrate on those aspects in which the FSA is concerned.

10. The first guiding principle has been accountability. I am conscious that a claim much advanced is that regulators are unregulated: powerful but unaccountable beasts, it is claimed. My own experience, in now two (very) different regulatory posts in the UK, does not bear this out at all. The accountability of the FSA is multiple: to the FSA Board (which has a

majority of non-executive directors: they include Tom de Swaan, recently retired from ABN Amro, David Miles, the senior European economist in Morgan Stanley, and James Crosby, recently retired as CEO of HBOS); to Parliament, to which we report annually and whose Treasury Select Committee regularly questions senior representatives of the FSA (John Tiner, the FSA CEO, and I last gave evidence to this Committee in September); and to those we regulate and those on whose behalf we regulate, at an annual public meeting (attended by several hundred people). At the bank, the Governor makes a comparable annual report, and comparable appearances before the Treasury Committee. “Quis custodiet ipsos custodiet?” is a fair question to raise. It is one in relation to those responsible for financial stability issues in the UK to which there is a good answer.

11. I should stress a negative, but an important aspect of accountability, namely the respect which Ministers have observed towards the statement that they have no operational responsibility for, and do not become involved in, operational aspects of either the Bank or the FSA I can vouch for this: Ministers regularly reply to Parliamentary questions about the work of the FSA by explaining that these are matters for the FSA not the Treasury. And on a day-to-day basis we are left to discharge our responsibilities without interference. It is an independence which not all financial regulators enjoy – and, of course, with independence comes greater responsibility.

12. Second, transparency. This is not only a question of clarity of responsibilities, but also of the manner in which those responsibilities are discharged. In their different areas of responsibility, both the Bank and the FSA have taken steps to develop transparency. The FSA has an annual cycle by which it publishes each January an analysis of the main risks it sees for the year ahead – The Financial Risk Outlook. Also in January, it publishes its Annual Plan, which sets out its budget for the year starting that April, the main objectives, and a series of milestones indicating by quarter when it plans to achieve its major tasks. And in May we publish our Annual Report, which allows its readers to compare our actions against our priorities. We are also as transparent as possible in respect of specific

policy proposals, with extensive use of consultation papers setting out our ideas before decisions are made. Last year we published 21 consultation or discussion papers. As well as the general process of consultation, there are special arrangements to consult practitioner, smaller business and consumer interests. The minutes of the FSA Board, necessarily tailored to respect to respect commercial confidentiality, are published on the FSA website once agreed. At the Bank of England, the minutes of all meetings of the Monetary Policy Committee are published within two weeks of its monthly meeting. These minutes include the votes of each of its nine members. I think it fair to say that both the bank and the FSA are significantly transparent.

13. On the avoidance of duplication, I see little of concern. The general allocation of responsibilities which is so clearly set out in the MoU has proved robust, and is increasingly understood by financial services practitioners whose historical reaction to an event or issue was to communicate with the Bank. This was undoubtedly assisted by the greater clarity in the Bank of England's own objectives, which have been focused on monetary and financial stability, with the recognition that what had previously been seen as a third core objective, namely the efficiency and effectiveness of the financial system, is best regarded as an important contributing factor to the two aims of monetary and financial stability. While the clarity of objectives has been key here, so has the willingness of all participants in this process to embrace fully the changes in their roles. Financial firms were left I no doubt from the start that regulatory issues were for the FSA and that the Bank would not seek to influence these in any way.

14. I have been concerned to ensure that the arrangements to avoid duplication, which work well in general circumstances, would prove robust in more trying and testing times. The actual tests of our ability to deal with a financial crisis which have occurred to date – the reactions to the LTCM problem, and to the terrorist attacks of 11 September 2001 and 7 July 2005 – are very different in nature, but they share the characteristic that none was a major London-based threat to financial stability, so in practice the arrangements have not been subject to severe stress. Probably the most

severe of the three were the considerable spill over effects to the UK of the huge disruption to markets in the US of 9/11. Even then, the test of our systems was not extreme. But both the Bank of England and the FAS have been concerned to test, with HM Treasury, their separate and their joint arrangements for handling a financial crisis. We have done so through a series of exercises, some involving just those three institutions, other involving market participants, designed to test our operational capability to manage a financial crisis, and to ensure that we each know what is expected of us, and of each other. The events of 7 July 2005 in London showed that these arrangements worked smoothly – as did the back-up arrangements in the financial institutions affected. But they were not a major set of problems to the financial system. This aspect of avoiding duplication – more positively of securing operational and effective joint working – will remain a priority.

15. Last, information exchange. The arrangements for exchanging information and views are well-established. Of course, these discussions are of necessity highly confidential. Disclosure of the substance, or even fact of them, is likely to be prejudicial to the effective conduct of public affairs. But it is legitimate for me, without in any way undermining that confidentiality, to give you an idea of the kind of issues which may be discussed. This could include, for example, current issues like the issues, both prudential and consumer protection, associated with hedge funds (on which the FSA has developed an extensive and much discussed policy); the extent of banks' exposure to property; the potential impact of a sudden and severe rise in oil prices; developments in reinsurance; operational aspects of derivatives trading; or the significance of the present concentration among global accounting firms. On a bilateral basis, the cross-membership of FSA Board and Bank Court makes for a close and continuous understanding by each of the other's agenda. I have a monthly meeting with the Governor to discuss matters of mutual interest. The FSA Chief Executive, John Tiner, meets senior Treasury officials each month for a comparable discussion. The FSA has a careful process for identifying those – relatively unusual – occasions on which we judge it appropriate to write to the Chancellor of the Exchequer under the terms of the MoU. In 2002/03, we wrote on 5 occasions; in 2003/04, on 3 occasions; in 2004/05, on 2

occasions; and not at all in 2005/06.

Wider issues

16. I have for the main been descriptive in my remarks so far. I would like to end by making some more judgmental comments, on the wider issues associated with the British arrangements for financial stability. I will confine myself to only four general comments.

17. First, I am struck by the acute difference in nature between the decisions on monetary policy which very properly occupy so much of the time of the Bank of England, or any other institution responsible for monetary policy, and those decisions on supervision which equally properly occupy so much of the time of the FSA, or any other institution responsible for supervision. The former, against a time table which is not immutable but is substantially fixed, essentially is the same decision – increase, hold or reduce – made repeatedly, on the basis of economic data and anecdotal evidence. It is a decision of obviously wide importance, and requires analysis and understanding of a very wide range of information. But it has the special feature that it is the same type of decision, where the many factors are reduced to one variable. Supervisory decisions, by contrast, come in very many forms: should this firm be authorized? Should that firm be disciplined – and if so how? What reliance should be placed on an individual, or on the senior management of a firm? Should more capital be required for an institution? The single minded focus on one type of decision which is possible in monetary policy is inappropriate in supervision, where a broader, less predictable and less time-tabled set of decisions are called for. I confess that I am at times envious of the clarity of the decision called for from those responsible for monetary policy – and I understand when they are sometimes sympathetic towards those of us who have to deal with a host of different supervisory issues. Now I make these points simply to observe that I think it difficult, though clearly not impossible, to combine both types of decision-making within one institution while developing the expertise required for each. Nor is it easy to develop a common culture which enables both types of decision to be made effectively. Supervisory decisions tend to be diffused throughout the

organization, and to be made efficiently at a variety of levels of seniority, with all the decision-makers needing to understand risk-based regulation. It is a very different culture when the purpose is analysis to support a single decision made by a high level, very senior group like the MPC in London or the FOMC in Washington. The organizational culture is very different. A benefit which I see from the different responsibilities of the Bank of England and of the FSA is the different focus, culture and expertise which each can develop. Many institutions are required to make both types of decision. I admire their ability to do so. But I am glad not to be called upon to do so.

18. Second, I should stress one aspect of the FSA's approach, namely that we set out to be a risk-based organization. This means that we examine what we identify as the main risks to our statutory objectives, and seek to deploy our resources and impose duties on others in a proportionate way so as to mitigate those risks where it is worth so doing. The operative words are "where it is worth so doing", for we do not judge all risks to be worth mitigating. In some instances, the costs of doing so would outweigh the benefits. The consequences of this approach are many, but some are worth spelling out. We allocate our resources highly selectively: firms which have the potential to have a major impact on our objectives – less than one per cent of all the firms we regulate – are subject to "close and continuous supervision", but we treat small firms very differently. We do not plan, in the normal course of business, to visit any of the more than 90 per cent of the firms which we regulate which we consider to be small firms, instead relying on thematic work or statistical analysis. We have significantly automated our authorization processes, so that detailed examination of firms seeking authorization is confined to a minority whose characteristics have required them to submit to a more detailed screening in a red channel, with the majority progressing via the green channel. In these, and other, ways we seek to make real a risk-based approach. I should add that, alongside our risk-based approach, we explicitly do not seek to prevent all financial failures, as a zero failure regime would be incompatible with the risk-taking which is necessary if there is to be financial return, and would inhibit innovation.

19. Third, I should point out that a feature of financial supervision in the UK is that we are indifferent to the nationality of those who either own or manage financial institutions within the UK. So, for example, when Bank Santander acquired Abbey, the sixth largest retail bank in the UK, there were a variety of questions, as you would expect, associated with such a major acquisition, but none of those questions was associated with the fact that Santander was a Spanish bank. The UK has benefited enormously from this approach. London is now home for very large trading activities of banks as varied as Citigroup, Deutsche Bank, Goldman Sachs, Société Générale and Morgan Stanley. We have benefited from the intellectual capital and energy which these and their non-UK firms have brought. I confess to some surprise that other regulatory regimes, in the EU and elsewhere, have on occasions taken a more restrictive approach towards the benefits which foreign ownership have so clearly brought to the UK, and which I would expect to bring to other countries as well.

20. Fourth, I should be clear that I see very considerable benefits from supervision of different sectors of the financial services industry being conducted by a single institution. In part, this is because the distinctions which used to occur between different sectors are becoming increasingly blurred. This occurs not only because of the breaking down of traditional cartels, under which home mortgages which were available historically only from building societies are now available from banks (and, indeed, some institutions which historically were building societies have become banks), but also because the historic distinctions between loans on the one hand and traded securities on the other are decreasingly relevant in a world of traded credit derivatives. But I am also conscious of the benefits in having a single risk-based approach which is consistently applied across different financial services. We have succeeded in making major advances in the assessment and reporting of capital requirements for life insurance companies by applying the same methods of analysis and approach to supervision which have long been adopted in banking, and it has been easier to make these advances because we already had within the FSA those with the necessary expertise. I do not believe the problems of insurance supervision – and still less the problems of reinsurance supervision – are unique to the UK. I do believe our integrated approach

within the FSA has significantly facilitated their solution.

21. I have explained the clarity with which responsibilities for financial stability were allocated within the UK between the Bank of England, the FSA and HM Treasury. I have explained how in practice this works, against the original guiding principles. And I have commented, from the FSA's viewpoint, on four important features of these arrangements. The UK model is clearly not the only possible model. But it is one which has brought manifest benefits to the British financial system and has a number of features that are well worth bearing in mind by anyone charged with assessing or changing regulatory structures.