Simple Rules for Complex Systems: Streamlining The UK's Financial Regulation Regime

Tim Ambler and Eamonn Butler

Adam Smith Institute, July 2012

Executive summary

The Financial Services Authority grew rapidly in the 2000s, to 4,000 staff . But its tick-box approach to regulation took its focus off fundamental issues and it was unprepared for the unfolding financial crisis. Hence George Osborne's decision to replace it with new agencies, the Financial Conduct Authority (FCA) for consumer protection and the Prudential Regulatory Authority (PRA) to supervise financial firms.

It is a mistake to have two regulators, second-guessing each other. They intend to be continuously monitoring financial firms, rather than just setting broad rules and punishing transgressions, which will increase the volume and cost of regulation on the sector. They also seem to have no understanding of the value of competition in regulating firms' activities; and their high regulatory cost will not encourage new firms to set up.

The FCA seems to believe that it can train new staff in a matter of months, and specify in detail how firms in a complex sector should compete. It has provided no performance measures by which its success or failure could be judged.

A better model for consumer protection is the Financial Ombudsman Service (FOS), which sets broad rules and deals with hundreds of thousands of complaints on a staff of just 1,000. The FOS could protect consumers well, without the need for a further regulator in the form of the FCA.

The Bank of England has recovered its supervisory role. In this, it must not be diverted into the bureaucratic tick-box culture of the FSA.

The Prudential Regulatory Authority is conflicted between saving troubled firms and ensuring the health of the financial system as a whole, which will require some firms to fail from time to time. Early signs are that it does not appreciate the regulatory role of auditors, shareholders and boards and will load more unnecessary bureaucracy and cost onto companies.

Where malpractice is found, there is confusion over whether individuals or firms should be penalised. Targeting individuals would be more effective. Auditors should also face personal penalties for failure.

The heavy price of French participation in the 2010 G20 meeting in London was to hand financial services rule-making to Brussels. We should ensure that EU-wide rules are enforced uniformly across the EU, and not gold-plated here.

George Osborne's plan to replace the FSA actually makes things worse, with more overlapping and conflicting regulators and greater costs arising from the bureaucratic tick-box culture. Regulation would be stronger if it were simpler. With this in mind, we recommend:

- The FCA is unnecessary and should be wound up
- The PRA should be slimmed and become an early-warning team to inform other regulators.
- The Money Advice Service, set up from the FSA, should be commercialised or dismantled.
- Regulators must understand and accept the role of brands and competition in bidding up service and value levels. The importance of boards, shareholders and auditors must be strengthened too.
- EU financial regulation must be enforced equally across the EU.
- The Bank of England must resist regulatory creep in EU regulation.
- Auditors and individuals must be personally accountable.

How the FSA ran out of road

The FSA was initially formed through a merger of existing specialist self-regulators. Under Chancellor of the Exchequer Gordon Brown, it grew rapidly, doubling in size from 2,039 staff in 2000/1 to 4,000 staff in 2009/10. Its responsibilities also grew, spreading into sectors such as insurance.

The FSA regulatory process was essentially a box-ticking approach, which proved ineffective and very expensive, while the regulatory burden stifled competition. Worse, the tick-box culture seemed to take the FSA's focus off the fundamental issues at the time when it mattered most. Not only did the FSA fail to intervene when they themselves had predicted that banking failures might be about to occur (as in the case of Northern Rock); they also failed to liaise with the Bank of England about the impending crisis. Instead, they were engaged in off-target initiatives such as setting out rules on how banks treat their customers, and an internal assessment of their own capabilities. The result was that the FSA did nothing to prevent or even mitigate the 2007/8 financial crisis. As we explained in the Adam Smith Institute report *The Financial Crisis: Is regulation cause or cure?* (2008), it was a key part of a deeply flawed and incompetent regulatory system that provided only the illusion, and not the reality, of control.

Although the FSA has investigated and levied fines on malpractice within financial firms since that time, no individuals have actually been brought to book. And more recently, it is only now that the FSA seems to have caught up with the Libor fixing malpractice – at least seven years after it started, and despite media warnings as far back as 2008 that it was taking place. Indeed, though the full story is yet to unfold, it looks likely that the FSA started taking an interest when Canadian and US agencies began to uncover the facts. (It is noteworthy that about three quarters of the £300m fine announced in June 2012 was levied by US, not UK, regulators.)

In the light of the FSA's ineffectiveness (which even it conceded), the Conservative Opposition let it be known before the 2010 election that they would abolish the FSA as soon as they came to power, which looked highly likely. Not surprisingly, this advance warning of the institution's demise created alarm within it, and many of the FSA's best staff began seeking other jobs.

Rattled, the Conservatives conceded that they would not move immediately on the abolition issue. In fact, on 16 June 2010, just ten days after the election, the new Chancellor of the Exchequer, George Osborne, announced proposals to replace the FSA with a number of new agencies and the Bank of England. The Financial Conduct Authority (FCA) would be responsible for policing the City and the banking system from the perspective of consumer protection. The other main part of the FSA would become the Prudential Regulatory Authority (PRA) and part of the Bank of England. Taking a market supply perspective, it would carry out the prudential supervision of financial firms, including banks, investment banks, building societies and insurance companies. These activities would support the Bank of England's new, or perhaps revised, Financial Policy Committee.

In addition to the FCA and PRA, the Financial Capability Division of the FSA broke away in 2010, and is now known as The Money Advice Service. This cost £44m in 2011/2 (£46.3m in 2012/3), paid by a levy on firms regulated by the FSA. This is a fine example of Government spending other people's money and it is hard to see how value for that money can be established, not least because of the Service's overlap with other quangos and initiatives. In the section of its business plan on working with stakeholders (we are not told who they are) it states "By working together we hope to build and maintain support for our Service while delivering the best outcomes for all our customers." It seems to be a case of motherhood and apple pie.

Perhaps surprisingly, then, and hydra-like, the FSA was chopped off but three heads grew in its place. Apart from the Chairman, Lord Turner and the CEO Hector Sants who had already resigned, existing FSA staff, it seemed, did not have to fear for their jobs.

The new arrangements

The two new agencies, the FCA and the PRA, will together increase the volume of supervision of the financial services industry. It seems inevitable that their own costs and the compliance costs within the industry will rise and will be passed on to consumers. As we will see, however, no industry needs more than a single regulator to referee according to the rules, any more than a football match needs two referees, each claiming authority.

Indeed, regulators that are continuously immersed in their markets stifle rather than encourage firm-level competition. This is because firms' creativity is diverted from innovation to please consumers to innovation to please the regulators. Furthermore, new market entrants are deterred by the raised costs of entry, part of which is the time and effort required to establish a positive relationship with the regulators.

Competition is the best regulator: but neither the FSA nor its successors seem to have any understanding of the need for greater competition nor the positive effect of competition on consumer choice and consumer protection. The present lack of competition is evidenced by the degree to which the banks operate as a pack. Reactions to media disclosures and public policy proposals are generally made by the British Bankers Association, the trade body, rather than by individual banks. We expect the final Libor-fixing story to reveal, as consumers have long grumbled, that all banks were doing much the same. The financial market needs to develop stronger and more diverse and competitive brands rather than be governed by tick-the-box supervision which creates uniformity.

As mentioned above, the costs of dealing with regulators are beyond the means of small firms. Accordingly regulators end up preserving the status quo, rendering the regulated (protected) firms unfit to meet competition in other world markets or in their own market when competitors do break through.

There are two kinds of regulator: (a) those who set the rules and thereafter merely investigate claimed transgression, like the OFT, and (b) those who are continuously involved with the regulated firms in terms of collecting massive amounts of data and intervening frequently and at many levels. When utilities were privatised the idea was to encourage firm-level competition so the regulators could move from (b) to (a). Clearly types (a) and (b) are good and bad for competition, and thus consumers, respectively. Equally clearly, the old Bank of England was type (b) and the FSA and its successors type (a), more concerned with their own welfare than the health of the industry.

One new bank, Metro Bank, has indeed entered the market, but the regulatory hurdles were considerable in terms of time and money. Partly because of these costs, it lost £56.5m in its first two years and only expects to break even in its fourth year.[1] Yet with consumer disenchantment with the big banks one might have expected a new entrant to have a relatively smooth ride.

---

[1] "Metro losses widen in first full year," Sharlene Goff, Retail Banking Correspondent, *Financial Times*, July 5, 2012

Consumer protection

Apart from general protection, where agencies such as the Office of Fair Trading (OFT) are also involved, the new consumer protection arrangements revolve around two specialist agencies: the FCA and the Financial Ombudsman Service (FOS). The latter is driven primarily by consumer complaints and the former by more general theoretical notions of desirable marketplace conduct. This difference means that their functions will inevitably overlap, collide and leave gaps where each think the other should be dealing with the matter just as we saw between the 'Tripartite' regulatory partners (the Treasury, the FSA and the Bank of England) in the run up to the 2007/8 crisis. In theory this will be averted by the Memorandum of Understanding being drawn up between the FCA and the FOS but this assumes that each agency has foreseen every possible future contingency. The Memorandum is unlikely to be any more watertight than the Tripartite Agreement drawn up in 1997 between the Treasury, the Bank of England and the FSA: when it hit the financial crisis iceberg, it failed. Unlike the Titanic, unfortunately, it did not take the chief officers down with it.

A vision of the future FCA is provided by its CEO-designate, Martin Wheatley in his paper *The FCA – Our Vision For Enforcement*.[2] Some might regard this 'vision' as mostly vague and meaningless, but things are more worrying than that: Wheatley seems to believe he can train new people in a few months to specify and enforce exactly how firms should compete in what is a highly complex sector. Why should an ill-informed, fledgling FCA know better how to do that than the firms themselves?

The document also makes no reference to performance measurement. How will we know if the FCA has achieved what it is supposed to achieve – or, indeed, has achieved anything at all, apart from spending taxpayers' money? What measures does it propose in order to monitor compliance? (Which is something the compliance departments of the regulated firms would like to know too.)

Nor does the 'vision' make any reference to the role of brands or to a marketplace in which firms compete on the strength their brands to attract and maintain customers, in benefiting consumers. This suggests it does not really understand some of the fundamentals of markets, nor cherish the value of competition itself as a regulator, constantly bidding up quality and bidding down prices.

Certainly, financial marketplaces should be regulated just as street vegetable markets should be; but the latter's regulations are fundamental, dealing with basic issues such as trading hours, cleanliness and redress for customer complaints. Broad rules like these can be left for decades

[2] Speech by Martin Wheatley - CEO Designate of the FCA - at the FSA's Enforcement Conference, London, 2nd Jul 2012

without needing to be changed. They do not require a large staff (we do not know how large yet), constantly intervening, as the FCA seems to envision.

Consider also the Financial Ombudsman Service, which is largely ignored in the FCA's media statements. Its actions are prompted by consumer complaints – unlike the FCA, which will decide for itself what it does and does not approve. With a staff of 1,000, the FOS handles hundreds of thousands of cases. And where complaints form a pattern, it can raise the matter with the Office of Fair Trading, the Bank of England or (via the Bank of England) even with EU regulators if necessary.

The Draft Memorandum of Understanding between the FCA and the FOS shows, almost by its existence and certainly by its content, that the FOS would protect consumers perfectly well, and probably better, without the FCA. All that would be needed is a quinqennial (say) rule-setting meeting between industry representatives and the Ombudsman, under Bank of England supervision. Thereafter the everyday activity of consumer protection could then be left to the FOS.

The new arrangements underplay the potential value of the FOS. A long list of quangos overlap with it – the FSA, the Information Commissioner's Office, the OFT, the Claims Management Regulator, the Lending Standards Board, the Pensions Ombudsman and other Ombudsman schemes – and now the FCA is to be added.

Of course any market requires consumer protection and consumers require choice. What is worrying is that the old *caveat emptor* approach, which put the emphasis on sensible shopping, has been replaced in the financial sector by an expectation that any losses incurred by consumers will be made good by regulators, no matter how credulous those consumers were. (The ultra-high interest rates being offered by some banks during the 2007/8 crisis, for example, should have warned any sensible investor of the risks involved.) The moral hazard created by that implicit guarantee is not good for consumers, for taxpayers, nor for financial services markets.

In short the FCA is not only unnecessary, its interventions are likely to be pernicious as it tries to compete with the other regulators and to second-guess the traders.

Prudential regulation

Before turning to the new Prudential Regulation Authority, let us consider the role of the Bank of England. When the Tripartite system was set up by Gordon Brown in 1997, the Bank was given two major tasks: managing inflation through interest rates (as decided by the Monetary Policy Committee) and ensuring financial stability (the role of the Financial Policy Committee). In practice, the Bank Governor, Sir Mervyn King, devoted all his attention to the former (with its 2½ -day monthly meetings) and only token attention (six-monthly *post-hoc* reports) to the latter. This lack of attention on financial stability within the Bank of England was a major contributory factor in the 2007/8 crisis, as was its inability to liaise meaningfully with the FSA.

But things are improving. The twin priorities of monetary and financial stability are, finally, in place together. The Bank has recovered its traditional supervisory role. We have yet to see whether it will also return to informal early intervention (which worked) or FSA-style box-ticking (which did not). The incoming Governor needs to be able to take the broad view, to have a thorough historical understanding of what has worked and failed before and to be free of the bureaucratic, legal and procedural trammels of recent years.

In this context, the Bank of England and the politicians do not seem to have grasped the basic conflict between their demands that banks should simultaneously (a) build capital and reserves and (b) lend more to struggling businesses. Arguably, much of the 2011/12 downturn is due to banks becoming tight with their money – not just on account of their past experience with bad debts, but also under the pressure of ministers and regulators to strengthen their capital and reserves. And arguably again, this is doing more harm than the original problem. Ministers, such as Vince Cable, make a lot of noise about the lack of loans without recognising that they themselves are partly to blame.

As for the proposed new prudential regulator, the best indicators we have so far on how the PRA will operate are found in a 27-page joint Bank of England and FSA publication.[3] That document makes it clear that the PRA is intended to win the last war, i.e. prevent the 2007/8 UK financial crisis happening again. Not that it ever will: no two crises are exactly alike and nor do they flow from the same causes even if they have similarities.

And the overview contains a fundamental contradiction: "The PRA's role will be to contribute to the promotion of the stability of the UK financial system. It will have a single objective — to promote the safety and soundness of regulated firms — and will meet this objective primarily by seeking to minimise any adverse effects of firm failure on the UK financial system and by ensuring that firms carry on their business in a way that avoids adverse effects on the system. As recognised in its statutory objective, it will not be the PRA's role to ensure that no PRA-authorised firm fails. That responsibility lies with each firm's management, board of directors and shareholders." So it is supposed to maintain the "stability of the UK financial system" by promoting "the safety and soundness of regulated firms" – which it then goes on to say is the firms' problem, not the PRA's. Should it "promote the safety and soundness of regulated firms" by intervening before the

[3] Bank of England, Prudential Regulation Authority: Our approach to banking supervision (May 2011)

firm becomes insolvent, or is it better for the health of the "UK financial system" as a whole that unsuccessful firms do fail from time to time?

Page 11 of the paper provides a vignette of the PRA's perspective. "A key element of the PRA's approach will be to recognise that management, internal audit, boards, shareholders, creditors and external auditors have an important role [note the use of the singular: there is no recognition of their different roles] to play in ensuring firms are run prudently." Meanwhile, paragraph 66 acknowledges that auditors have a role "in supporting prudential supervision". The whole tone suggests that the PRA sees itself as being in charge of how companies operate, with managers, auditors, directors, shareholders and creditors being minor players in support.

However, much more attention should be given, in the post-FSA era, to the role of auditors – who manifestly made no contribution to avoiding the 2007/8 crisis. When banks are going bust, should not auditors detect that and advise boards on corrective action? Part of the problem, as we have noted before, is that auditors are appointed by and answerable to directors, not shareholders. Audit committees, we believe, should be chaired by senior shareholders, not directors; and auditors should be elected by, and answerable to, shareholders.

In looking to see if the PRA/BoE approach to market stability will be box-ticking or intelligence-led diagnostics, paragraphs 71-74 make it clear that it will be the former. Paragraph 72 puts this in bold "**Data submitted to the PRA should be of the highest quality given that they will form the basis of the PRA's supervisory approach and will form a key input to analysis for the FPC**."

We are not told what type of data will be required nor how it will differ, if at all, from the data required by the FSA – which proved so clearly ineffective. What the in bold statement says is that this is going to be a post-hoc box-ticking, number gathering operation, not an intelligent anticipation of outcomes.

Finally, we do need some administrative support for the Bank's Financial Policy Committee and the Bank needs the scouts it used to have to bring in the market reports on firms that need to have discussions with the Bank of England, but that is nothing like the numbers the PRA must have in mind to conduct all their data gathering and other interventions. Bear in mind that for every bureaucrat the PRA employs there must be at least one counterparty in the regulated firms. And ultimately British taxpayers bear the cost of both, using whatever money is left after the US lawyers and regulators have filled their pockets.

Prosecutions, fines and bans

Both the Libor scandal and the 2007/8 crisis have highlighted confusion over the powers of regulators. They extent to which they can level fines and bar executives from office is carefully legislated, but the FSA in particular still seems confused. Clearly, criminal matters should be dealt with by the police, e.g. the Serious Fraud Office, and Crown Prosecution Service; but they have lost so many cases that they are nervous of undertaking further ones.

There is the confusion over whether individuals should be penalised, or their employing firms. In the Libor case for example, the Barclays fine really only hurts the shareholders who are completely innocent, whereas the wrongdoers retain their bonuses and, in many cases, their jobs. Penalties would be much more effective if they were targeted at individuals and not firms, except where the regulators and prosecutors can show that almost all the management were involved.

Perhaps the auditors, who thus far have escaped Scot free, should also face personal penalties.

It is noteworthy that the US sends financial malefactors to gaol, whereas the UK does not.

EU and international considerations

In a disgraceful piece of personal aggrandisement, Gordon Brown persuaded the French Premier to attend his G20 summit in April 2009, by acquiescing in the French-led proposal that EU financial regulation should all be transferred to Brussels, and not separately conducted by member states. Member states would supervise, i.e. referee the rules, but would not create the rules themselves.

As we wrote in *The Times* in June 2010, there was a heavy price to pay for French participation in the summit. Financial services regulation would be handed over to EU executive committees. Monitoring UK compliance with the rules would be largely left to the British Financial Services Authority (FSA), but the rules themselves would be written in Brussels. So while the UK has by far the largest financial services sector in Europe, it would be only one of 27 voting members in determining what the new rules on the sector will be and how supervision would be done.

Curiously perhaps, this transfer of regulatory power to Brussels was not opposed by the Conservatives, apart from some lone voices like Bill Cash MP, nor even by the City. Indeed, the City might well prefer Brussels to UK regulation because:

- It is more ponderous and changes are slower.
- As EU law takes precedence, all UK regulations are gold plate.
- It may benefit the UK if all countries had the same financial regulations. (Though that could be naïve. Having the same rules and playing by them are two different things.)

Be that as it may, the Brown government gave formal consent to this regime in July 2009 and the detail, unchallenged by the

Coalition, is still wending its way though the EU legislatures.

The UK is represented at the EU negotiating table by the Bank of England and, in all fairness, they seem to be making a good fist, at least so far, of defending UK interests. However, the Libor scandal has prompted EU negotiators (and France in particular) to attack British interests, notably with a bank transactions tax scheme (the 'Tobin tax'). Such matters are of course entirely unrelated but it was this technique of oblique pressure on other fronts that caused Tony Blair, for example, to give away the UK rebate that Margaret Thatcher successfully battled for.

Lessons from Libor

We do not yet know how the numbers employed by the FSA's successors will compare with the FSA's current headcount of 4,000 but it is a safe bet that there will be more, later if not immediately.

The type (b) continual-engagement regulators currently being set up should, as a minimum, have clear goals and performance measurement to discourage regulatory creep and to make them accountable.

But that would be a dismal continuation of the FSA's box-ticking approach which has proved so burdensome and ineffective. Gathering the day before yesterday's detailed data, after massaging, will never be a substitute for intelligent analysis of how the financial market is operating today.

The Libor scandal is a fine example of that. Even when the defects were drawn to the FSA's attention in 2008, nothing was done. Yet the solution is perfectly simple and does not require endless committees. Separating retail from investment banking will be no solution if the traders and the submitters of the interest rates are part of the same organisations, Chinese walls or no Chinese walls.

What should happen is that the firm contracted by the British Bankers Association to consolidate the figures should also be contracted to collect the data from their sources and ensure their probity, .e.g. by checking claimed interest rates by payers with payees. In other words, the role of the submitters should be taken out of the bankers' network.

It is not too late: what should be done instead

Regulation of UK financial services, and supervision of those regulations, would be strengthened by simplification:

- The FCA is unnecessary and should be abolished leaving consumer protection primarily to the FOS, supported by the OFT and Bank of England. The importance of caveat emptor should be promoted to reverse the current tide of consumers demanding reimbursement even when they only have themselves to blame.

- The PRA should be dramatically slimmed down and converted from the box-ticking bureaucracy now envisaged to an intelligent market sensitive team of scouts supporting the Financial [Stability] Policy Committee. Remember that for every bureaucrat in the PRA there will be at least one counterparty, i.e. a compliance officer employed by the supervised firm. The cost of the PRA as envisaged is at least double whatever they report.

- The Money Advice Service should be put onto a commercial footing, with fees paid by its customers, rather than being levied on the finance sector as a whole. If customers are happy to pay for its services, that is justification for its existence, in a way that a compulsory levy is not.

- Financial services regulators and supervisors should be brought to understand the importance of brands and competition to improve choice, value, quality and innovation for consumers. The idea that free markets are now old hat and should be replaced by a new era of ever-increasing regulation may be fashionable but it is also wrong. Look no further than Communist Europe in the second half of the 20th century for the consequences of state control. Consumers need more competition and easier market entry not more costs from ill judged regulators.

- It is now too late to recover financial regulation from Brussels but the UK should ensure that it becomes a truly level playing field and not one where the rules are applied and supervised strictly in the UK but with laxity elsewhere.

- The principle that simpler regulation is better regulation applies also in the EU. The Bank of England will need to be on guard against regulatory creep from Brussels. Again, this cannot be addressed by routine data collection but with pro-active campaigning for what the rules should say. The UK too often finds itself on the back foot defending itself against continental initiatives, e.g. the Tobin tax, rather than putting forward its own proposals.

- Auditors and executives must be personally accountable. Even large fines make little impact on large firms: cash may move from one treasury to another and bonuses barely dented. Auditors should be appointed by, and answerable to, shareholders.

All of the current developments add up to a sad outcome to Osborne's original boast that he would abolish the FSA and clean up City regulation: his solution looks to be even worse than Gordon Brown's, which is quite an achievement. As with the old Tripartite system, too many bodies are involved, both in London and in Brussels, too many are employed by the regulators and they in turn create too many counterparties in the firms themselves. When crises arise no one will know who is supposed to be doing what and between times competition will be stifled.