

The fate of the Financial Services Authority : Brought back from the brink Or on the tip of a precipice?

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Introduction:

It has not just been the electorate which has been held in turmoil in recent days but also the fate of the Financial Services Authority (FSA) and the Bank of England regarding their future role in financial regulation. Now that the United Kingdom (UK) has a coalition government between the Conservatives and the Liberal Democrats, the fate of both of these power houses in banking regulation are a little clearer. Or are they? The proposed new deal announced on the 12 May 2010 outlines the new government's plans for financial regulation and reform. This paper examines the pre-election promises and how a hung-parliament has altered the coalition government's opinions as to the future of financial reform. Firstly, the paper therefore examines firstly the background to the reform and why banking reform was at the forefront of the political agendas pre and post election. Secondly, the paper looks at the banking regulation pre-election promises made by both the Conservative and the Liberal Democrats. Thirdly the paper examines the 'new deal' plan set out under the new coalition government. The paper concludes by postulating what the future may hold for the FSA.

Background to the crisis and the need for reform:

Since early 2007 the UK, like the rest of the globe, has been immersed in a financial crisis which has been described as the worst in living memory (Handbook of Internet Crime 2010). The failure of Northern Rock was the catalyst for the UK's economic crisis and the beginning of the recognition that the FSA was not living up to its objectives. The FSA was created under the Financial Services and Markets Act 2000 (FSMA 2000). The FSA was given statutory power through four objectives(s36) FSMA 2000 outlines the ethical and moral guidelines for prudent regulation within the financial industry. These being: to maintain consumer confidence; to maintain market stability; to enhance consumer awareness; and to protect the market from financial crime. As Northern Rock was encountering its first run on any UK bank since Victorian times, the government and the public questioned the role that the FSA played and should have played in regulating this financial institution. Questions were asked as to whether the FSA could have stopped the failure of Northern Rock. Four

months on from the failure of Northern Rock a report outlined the FSA's failure in its regulation. The FSA has, since its conception adopted a micro-prudential regulatory standpoint over the industry. In other words they monitored and regulated each individual firm against its benchmarks. They did not provide a macro-prudential regulation for the UK's financial services industry. The report, 'The Run on the Rock', determined that the FSA had failed in its duty to regulate the financial services industry sufficiently so as to prevent this bank from failing. (HM Treasury. The Run on the Rock <http://www.parliament.the-stationery-office.co.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf> accessed 12 May 2010) The report denotes that, "the FSA systematically failed in its regulatory duty to ensure that Northern Rock would not pose a systematic risk", (p.5) to the rest of the industry. This was because of their oversight of the macro-prudential regulation and in some cases their micro-prudential regulation.

The report is also critical of the relationship of the tripartite authority's, the FSA, the Bank of England and HM Treasury. The report cited that power struggles and differences led to poor leadership and a lack of control over the regulation. The report stated that the members of the tripartite authority were not capable of managing the collapse of Northern Rock. This was put down to the tangled web of tripartite regulations which the government could not break through in time to save the bank. We must remember at this standpoint that the government was in the last throws of a thirteen year administration and at the height of the worst financial crisis since the Great Depression. The government, or indeed any government with these occurrences happening on 'their watch' would aim to lay the blame elsewhere. As a result of the report into the collapse of Northern Rock, the Government created the post of Deputy Governor of the Bank of England and Head of Financial Stability, thus ensuring a tension (??) was created between the FSA and the Bank of England to ensure no regulatory oversight should occur again.#

The relationship between the FSA and the Bank of England began with the new political dawn in 1997 and the Labour Government, which took away its supervisory power of banks in 1998 with enactment of the Bank of England Act (s. 21)=. Supervision of banks were placed in the hands of the FSA and taken from the Bank of England. Some eleven years later regulatory supervision and oversight for banking stability was once again handed back to the Bank of England, yet full supervision was left with the Bank of England. This was to become the pivotal electoral talking

points on banking reforms. To reform or to replace and abolish the FSA, that was the question.

Pre-election promises

The Labour White Paper

Labour's reform proposals are as such: to maintain the current tripartite system; to create a new council for financial stability; to require banks to hold more capital to cover future losses; to require the FSA to annually report on the new code of conduct for banking remuneration; to create national debt advice lines for consumers; and, to require the FSA and Office of Fair Trading to ensure greater banking competition in an open and free market. All in all one could say that these were lacklustre and austere reforms which lack any admittance of wrong doing nor any desire to pave the way forward for effective reforms, which would in turn build a secure economic future for the United Kingdom. Instead they are safe, guarded, un-tumultuous and bland which will neither reform nor make any inroads to reform the financial crisis. It is a safe white paper for an election year, given by a party already barely keeping their head above the legislative quagmire. (Chambers, C. L. The Reforms: A political safe haven or political suicide. Is the Labour bubble bursting? Journal of Financial Regulation and Compliance. 2010)

The Conservative proposal

In response to the Labour's White Paper, the Conservatives published their White Paper response; From Crisis to Confidence: Plan for sound banking. July 2009. (http://www.conservatives.com/News/News_stories/2009/07/Our_plan_for_sound_banking.aspx) Within the paper they suggested radical changes and upheavals for the financial sector. These can be summarized by the following: Abolish the Financial Services Authority (FSA) and the Tripartite regime it operated with the Bank of England and the Treasury; Create a strong and powerful Bank of England with the authority and powers necessary to ensure financial stability; Create a powerful Consumer Protection Agency that will bring together in one place the consumer powers currently split between the old FSA and the Office of Fair Trading; Demand that banks set aside much more of their own money for their risky lending as a form of insurance policy; Appoint a Treasury Minister with special responsibility for fighting our corner in Brussels so that European regulations are right for the City of London; and, to Ask the Office of Fair Trading and the Competition Commission to conduct a focused examination of the effects of consolidation in the retail banking sector. (Osbourne. Osbourne launches White Paper on financial regulation Monday, July 20

2009) (Chambers, C. L. The Reforms: A political safe haven or political suicide. Is the Labour bubble bursting? Journal of Financial Regulation and Compliance. 2010)

In terms of abolishing the FSA the Conservatives were demonstrating their belief that it the failure of Labours regulatory regime which has contributed to the economic crisis. This was a brave move. The FSA was created after the enactment of the FSMA 2000, under which financial services came under a single regulator. The FSA was meant to be the panacea for preventing future financial crisis and scandals, neither of which they achieved. However, it achieved a great deal of control and governance over the industry and strengthened the regime. By the Conservatives stating that they will abolish the FSA it is an enormous blow to Labour. Yet it is a chess piece move for the general election. The Conservatives took a stand and want to reform the economy on their own ground with their own rules. Change it was recognised was required and as Albert Einstein, quote by Jesse Norman stated, "We cannot solve problems with the same kind of thinking that was used to create them". (Jesse Norman, Compassionate Economics 2008). (Chambers, C. L. The Reforms: A political safe haven or political suicide. Is the Labour bubble bursting? Journal of Financial Regulation and Compliance. 2010)

By restoring the power of the Bank of England, taken away by the Labour Government (Bank of England Act 1998 s21), the Conservatives were directly contradicting Labours policy. The Bank of England having more power will be able to be more in control of the banking system in the UK. The Central Bank will play a more central role. The Bank will be responsible for the macro-prudential regulation which is presently missing in the current Labour's regime. Furthermore the Bank will also be responsible for the micro-prudential regulation of individual firms, a somewhat 'joined up' approach, to coin a classic Labour phrase. This means that under one roof, both macro and micro prudential regulation will be considered and this hopefully will mean a more robust regulation of the financial services market. Additionally the Bank will be responsible for the financial stability of the UK, a sensible choice given its role as Central Bank. (Chambers, C. L. The Reforms: A political safe haven or political suicide. Is the Labour bubble bursting? Journal of Financial Regulation and Compliance. 2010)

The Lib Dem compromise

Liberal Democrats put forward the following banking reform proposals. To abolish the current tripartite system; to maintain the FSA as single regulator but to ensure

that the Bank of England Governor has the overall responsibility for systematic stability; to require highly paid bankers to publish details of their remuneration; to retain a long time role for state banking; to break up the publically owned banks such as RBS and Lloyds; and, to abolish the current Asset Protection Scheme (insuring the banks' riskiest assets). These reforms are the middle ground of both Labour's and Conservative proposals. The party acknowledges that the tripartite has failed to regulate the industry sufficiently yet it lacks the strength of the Conservatives to place control back with the Bank of England, and maintains the faltering FSA. The reforms too highlight the areas of public displeasure such as banker's remuneration and the nationalized banks. The reforms are safe and not the solid foundations on which economic recovery can be built. (Chambers, C. L. The Reforms: A political safe haven or political suicide. Is the Labour bubble bursting? Journal of Financial Regulation and Compliance. 2010)

The compromise

Banking Reform

What happened on the 6 May 2010 took all of the UK and the world by surprise. A hung parliament although proffered as an option was not a realistic contender. However four days after the election the UK is facing one of its toughest political changes to date. In government is a coalition between the Conservative and the Liberal Democrats. As we can see above, their reform ideas on banking were juxtaposed around the issue of whether the FSA should be kept or abolished. The Lib Dems were the middle ground of the Conservative and the Labour election promises. And as the new deal on party coalition was brokered we can see that the Conservative have had to yield on some of their most important arguments surrounding the FSA. As some media outlets purported, the FSA may survive to live another day, despite the conservative promise. (Insurance Age 12 May 2010. <http://www.broking.co.uk/insurance-age/news/1636183/possible-future-fsa-despite-tory-promise> accessed 12 May 2010) What most commentators are calling for it's a more middle ground reform for the FSA. Corrigan states that, "improving the regulatory system involves two factors: adjusting the rules where necessary; and implementing them more effectively – ideally without restricting the lending to companies that is vital to economic recovery". (Corrigan. T. Why the FSA's reprieve is good news for the city and the country. 12 May 2010. The Telegraph. <http://blogs.telegraph.co.uk/finance/tracycorrigan/100005600/why-the-fsas-reprieve-is-good-news-for-the-city-and-the-country/> accessed 12 May 2010)

So what are the promises that are being made now that we do have a coalition government and compromise is definitely what is needed? The new deal plan (and that sounds very labourist even to begin with) asserts that there needs to be reform to ensure that the crisis just experienced is never repeated and that the economy needs to be competitive and to sustain recovery, including protecting and sustaining jobs. (BBC News. Full Text: Conservative/Lib Dem Dealhttp://news.bbc.co.uk/1/hi/uk_politics/election_2010/8677933.stm accessed 12 May 2010)

The plan outlines many issues these being:

- To introduce a banking levy.
- To tackle excess remuneration for bankers which promulgate excessive risk taking within the market and thus reducing risk.
- To create a competitive and balance banking industry with more diversity and help for promoting mutals.
- To support the flow of credit for SME's, including major loan guarantee scheme, the use of net lending targets for the nationalised banks.
- To reduce systematic risk.
- To establish an independent commission to investigate separating retail and investment banking.
- To bring forward the proposals to give the Bank of England control over Macro-prudential regulation and oversight of micro-prudential regulation.
- Finally, to rule out joining the Euro during the term of the agreement. (BBC News. Full Text: Conservative/Lib Dem Dealhttp://news.bbc.co.uk/1/hi/uk_politics/election_2010/8677933.stm accessed 12 May 2010)

The FSA's uncertain future

The FSA therefore appears at first glance to have gained a reprieve from being dismantled and engulfed by the Bank of England, however, reform is coming and the role of the Bank of England, from the above, can be noted as to be gaining in strength. These reforms, can be seen, by commentators who have followed the economic crisis and the ensuing plethora of policy documents stemming from each of the tripartite authorities to be picking up on the collegiate issues outlined in these. Issues such as governance of banks, remuneration of banks, maintaining capital flow

to SME's, providing alternative financial providers to society and separate the retail from the investment arms of banks et al, have been outlined before in previous policy documents. Having said this though, reform is needed and these are important issues to tackle. What can be said is that the reforms are a compromise, on both parties behalf, but that reform is going to be had. The future of the FSA has therefore been rocked, whether more power is given to them but under the careful supervision of the Bank of England or whether they are phased gradually, only time will tell. Like with the final result of the election, the fate of the FSA will be clear in time.