

# FROM CRISIS TO CONFIDENCE: PLAN FOR SOUND BANKING

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Policy White Paper

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# **FROM CRISIS TO CONFIDENCE: PLAN FOR SOUND BANKING JULY 2009**

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# Foreword

by George Osborne MP

This White Paper sets out the Conservative plan for sound banking that will lead the British economy from crisis to confidence. It is an essential component of a sustained economic recovery.

The financial crisis of the last two years represents a policy failure of historic proportions. The failure of the tripartite system of regulation created by Gordon Brown, and a decade of fiscal imprudence, meant Britain was more exposed than most countries to the international banking shock. An unsustainable boom has been followed by a deep bust.

We must never repeat the mistakes of the last decade, in which we built an illusion of growth on the biggest mountain of debt ever seen in an advanced economy. A fragile return to stability in the banking system must not be used as an excuse to reflate the debt bubble with just a few tweaks here and there.

Responsibly managed and regulated financial services are a vitally important British industry that employs hundreds of thousands of people. Conservatives want that industry to succeed, compete and grow. We must not allow ill-conceived or badly designed new regulations, either from home or abroad, to undermine the prospects of an internationally successful financial services industry based in London and other centres of excellence around the country.

Yet given the scale of the misery and hardship inflicted on the public by the failure of the existing system, reform must be far-reaching to match the scale of the problem. British financial services must be internationally competitive without putting economic stability at risk. Strong regulation by able regulators benefits the financial services industry as well as the wider economy.

The crisis has also revealed that large parts of the financial sector had a free option at taxpayers' expense. Profits were privatised during the good times, but because we cannot allow the banking system to fail, losses were socialised when things went wrong. That is why we need a strong regulator with the power to exercise judgement and able to insist that the financial sector serve the long term needs of the broader economy, not just its own short term interests.

Last autumn I commissioned Sir James Sassoon, formerly a Managing Director at the Treasury, to conduct a review of the tripartite structure. This paper builds on that review and sets out the fundamental reforms a Conservative Government will undertake.

We will abolish the failed tripartite system and give the Bank of England responsibility for maintaining financial stability. We will give it responsibility for the prudential regulation of all of our banks, building societies, and other significant financial institutions including insurance companies. Crucially, this will bring together the operation of monetary policy with regulation of the banking system so that the economy is not built on debt.

We will give the Bank of England the power to regulate the pay structures, riskiness, complexity and size of financial institutions, and require those with structures that put financial stability at risk to hold large amounts of capital as an insurance policy to protect the taxpayer.

We will abolish the Financial Services Authority, and will create instead a strong new Consumer Protection Agency. This will take responsibilities to protect the consumer that are currently and confusingly divided between the FSA and Office of Fair Trading, and place them in a single powerful body able to stand up for consumers and ensure they are treated fairly.

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We will defend the vital interests of Britain's financial services sector in Europe. A senior Treasury minister with responsibility for European financial regulation will spend as much time as necessary in Brussels to build alliances and defend Britain's interests.

We will 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. The findings of the OFT and the Competition Commission will help to inform a Conservative Government's ongoing strategy for disposing of its banking shares.

The proposals presented in this White Paper represent the real change that will underpin financial and economic stability in the decades ahead. The public now have a clear choice: if they want to change the way their banks are regulated they need to change their Government.

A handwritten signature in blue ink that reads "George Osborne".

**George Osborne MP**  
**Shadow Chancellor of the Exchequer**

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# Executive Summary

The origins of the financial crisis lie in a complex interaction of underlying macroeconomic imbalances, poor understanding of the risks created by financial innovations and weak regulation of financial institutions. These led to a rapid and unsustainable increase in leverage and debt. British households and banks became the most indebted of any major economy in history, leaving the British economy particularly exposed to the crisis.

At the same time consumers have suffered as a result of irresponsible lending and unfair practices. And when the crisis broke, the free option at the heart of the banking system was exposed. We cannot continue with a system where banks make huge profits in the good times but benefit from an implicit taxpayer guarantee when things go wrong.

If we are to minimise the chances and scale of future crises we need a policy framework that has both the analytical capacity to bring together these different factors and the corresponding powers to act decisively when risks are identified. In contrast Britain's existing tripartite framework is confused and fragmented, with responsibilities, powers and capabilities split awkwardly between competing institutions.

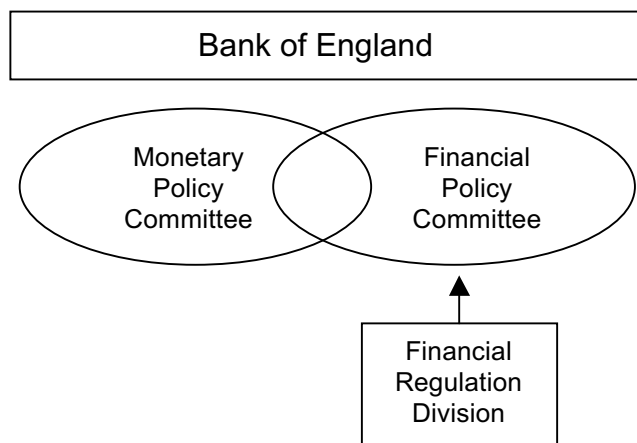
The result is that nobody identified the underlying problems as they built up and nobody had the power or authority to act once the crisis hit. We need fundamental reform to align our regulatory system with our new understanding of what it takes to ensure economic stability in world of globalised financial markets.

## ***A strong and powerful Bank of England***

We will abolish the FSA and the failed tripartite system and create a strong and powerful Bank of England with the authority and powers necessary to ensure financial stability.

- We will make the Bank of England responsible for macro-prudential regulation, judging and controlling risks to the financial system as a whole. This will restore the Bank's historic role in monitoring the overall level of credit and debt in the economy.
- We will create a powerful new Financial Policy Committee within the Bank, working alongside the Monetary Policy Committee, which will monitor systemic risks, operate new macro-prudential regulatory tools and execute the special resolution regime for failing banks.
- The Financial Policy Committee will include independent members in order to bring external expertise to bear on the problem of maintaining financial stability. It will include the Governor and the existing Deputy Governor for Financial Stability, who also sit on the Monetary Policy Committee, in order to ensure close coordination between monetary and financial policy.
- We will make the Bank of England responsible for the micro-prudential regulation of all banks, building societies and other significant institutions, including insurance companies.
- We will create a new Financial Regulation Division of the Bank to carry out this micro-prudential role, headed by a new Deputy Governor for Financial Regulation. The work of the Financial Regulation Division will be overseen by the Financial Policy Committee to ensure close coordination between macro-prudential and micro-prudential regulation. The Deputy Governor for Financial Regulation will also be a member of the Financial Policy Committee.

- We will reform the structure of the Bank to reflect its new responsibilities. The new structure of the Bank of England will ensure that monetary policy, financial stability and the regulation of individual institutions are closely coordinated.



- Given the Bank’s broader range of responsibilities, the new structure will also reduce the institutional reliance on the position of Governor, with a collegiate approach to policy on financial stability and more use of external expertise. This will build on the collective responsibility model of the Monetary Policy Committee, which also includes external members.
- We will conduct a review in government, involving the Governor of the Bank of England, to consider the case for putting housing costs back into the inflation target. Given the fragility and uncertainty in financial markets, any change to the measure of inflation should be carried out in a careful and considered way, with extensive consultation.
- We will also ensure that the Bank has the resources needed to offer salaries that are sufficient to recruit and retain high-quality regulators. This will mean increasing the industry levy, which will continue to cover the cost of financial regulation under the new arrangements.
- We will also increase the expertise at the Bank by requiring regulated firms to participate in a secondment programme. This will help to bring more market experience to bear on the task of regulation.

### ***New regulatory tools to ensure financial stability***

While changing the regulatory architecture in the UK is crucial, we also need to look at regulatory policy. We need a new “toolkit” of policy instruments that work at both the micro (institutional) and macro (sector) level in order to ensure financial stability.

- We will empower the Bank of England to ensure that capital and liquidity requirements recognise the additional risk implied by an institution’s size and complexity.
- We will empower the Bank of England to impose much higher capital requirements on high risk activities such as large scale proprietary trading carried out by banks that also take retail deposits. In practice this could prevent banks that take retail deposits from engaging in many of these high-risk activities by making them more expensive. At the same time the Bank will examine the case for a more structural separation of these activities in international policy forums.

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- We will empower the Bank of England to use capital requirements to crack down on risky bonus structures. From the banks' point of view this will effectively introduce a 'tax' on risky bonus structures that incentivise employees to seek short term profits at the expense of longer term stability.
  - We will introduce additional safeguards against the risks created by complex or interconnected institutions through greater central counterparty clearing, a more appropriate balance between exchange-traded and over-the-counter securities, and more financial transparency.
  - We will work at an international level to create a resolution regime for the orderly failure of investment banks and to design a resolution regime for international banks. We will also enforce the Governor of the Bank of England's calls for financial institutions to prepare a 'living will' to assist with any wind-down.
  - We will introduce a "backstop" leverage ratio limiting how much banks can lend for a given amount of capital. The Basel Committee is currently looking at how such a ratio could be designed. We support this work and believe that a properly designed and internationally agreed leverage limit could provide an additional safeguard for the financial system.
  - We will develop an internationally coordinated macro-prudential toolkit that can be operated by the Financial Policy Committee to control systemic risks at a sector or economy wide level. We will work with the Financial Stability Boards, the Basel Committee and other key fora to achieve international agreement on policy tools.
  - We will continue to press for reforms at an international level to introduce counter-cyclical capital requirements. We first called for this over a year ago.
  - We will actively shape the intellectual debate on European and global regulation more effectively than is happening at present.
  - We will ensure that there is a single senior Treasury minister with specific responsibility for European financial regulation. That minister will spend as much time as necessary in Brussels to ensure that the Government is fully engaged in the legislative process, build alliances, and defend Britain's vital interests in an industry crucial for our national prosperity
  - We will further strengthen the Treasury's engagement in Europe by enhancing the team dealing with European issues, and we will ensure that the Chancellor regularly attends meetings of European finance ministers. We will also begin a new programme to target the positions in the European Commission to which it would be in the UK's interest to second civil servants.
  - We will fight any new attempt to create an executive pan-European supervisor.
  - We will increase European opportunities for UK financial firms by eliminating barriers to entry to European markets for retail financial services, for example by developing proportionate pan-European conduct of business rules in insurance and fund management.
  - We will continue to support international efforts to reform the financial markets. In particular we believe Britain should seek to play an active role by working with the European and American authorities to find constructive solutions to trans-Atlantic disagreements on areas such as accounting standards, transparency and hedge funds.

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## ***Better consumer protection***

The Conservative Party has had long-standing concerns about poor consumer protection in the financial services sector. Consumers have suffered as a result of bad advice and mis-selling, and from a lack of competition in some markets. We believe that the regulatory architecture and culture needs substantial reform in order to provide proper protection for consumers.

- We will create a powerful new Consumer Protection Agency (CPA). The CPA will take a much tougher approach to consumer protection and will be given a mandate to act as a consumer champion. It will be a far more consumer-orientated, transparent and focused body than the FSA.
- We will transfer the regulation of consumer credit from the Office of Fair Trading to the CPA. This will create a unified regulatory regime for financial services firms and consumers.
- We will ensure that the CPA names and shames firms which break the rules. This will act as an incentive for firms to improve their behaviour.
- We will force banks to be more transparent about their retail consumer charges. Effective competition relies on consumers being able to make informed choices. Increasing transparency on charges will help consumers compare products. This approach is also being pursued by the Obama administration in the US.
- We will 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. The findings of the OFT and the Competition Commission will help to inform a Conservative Government's ongoing strategy for disposing of its banking shares.
- We will look to reduce barriers to entry for new banks and building societies in order to increase competition and diversity in the UK banking market.

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# Part 1: What went wrong

It is almost two years since global credit markets froze up in August 2007, triggering first a credit crunch and then a full blown financial crisis. The devastating scale of the resulting damage to Britain's economy and public finances as underlying weaknesses were exposed is increasingly clear, as are the lessons for how we need to reform our system of financial regulation.

Unless we learn the right lessons from this crisis we risk repeating the mistakes of the last ten years. A fragile return to stability in the banking system must not be used as an excuse to carry on largely as before. Reform must be far-reaching to match the scale of the problem.

The origins of the financial crisis lie in a complex interaction of underlying macroeconomic imbalances, poor understanding of the risks created by financial innovations and weak regulation of financial institutions. These led to a rapid and unsustainable increase in leverage and debt. British households and banks became the most indebted of any major economy in history, leaving the British economy particularly exposed to the crisis.

At the same time consumers have suffered as a result of irresponsible lending and unfair practices. And when the crisis broke, the free option at the heart of the banking system was exposed. We cannot continue with a system where banks make huge profits in the good times but benefit from an implicit taxpayer guarantee when things go wrong.

If we are to minimise the chances and scale of future crises we need a policy framework that has both the analytical capacity to bring together these different factors and the corresponding powers to act decisively when risks are identified. In contrast Britain's existing tripartite framework is confused and fragmented, with responsibilities, powers and capabilities split awkwardly between competing institutions.

The result is that nobody identified the underlying problems as they built up and nobody had the power or authority to act once the crisis hit. We need fundamental reform to align our regulatory system with our new understanding of what it takes to ensure economic stability in a world of globalised financial markets.

## *The scale of the crisis*

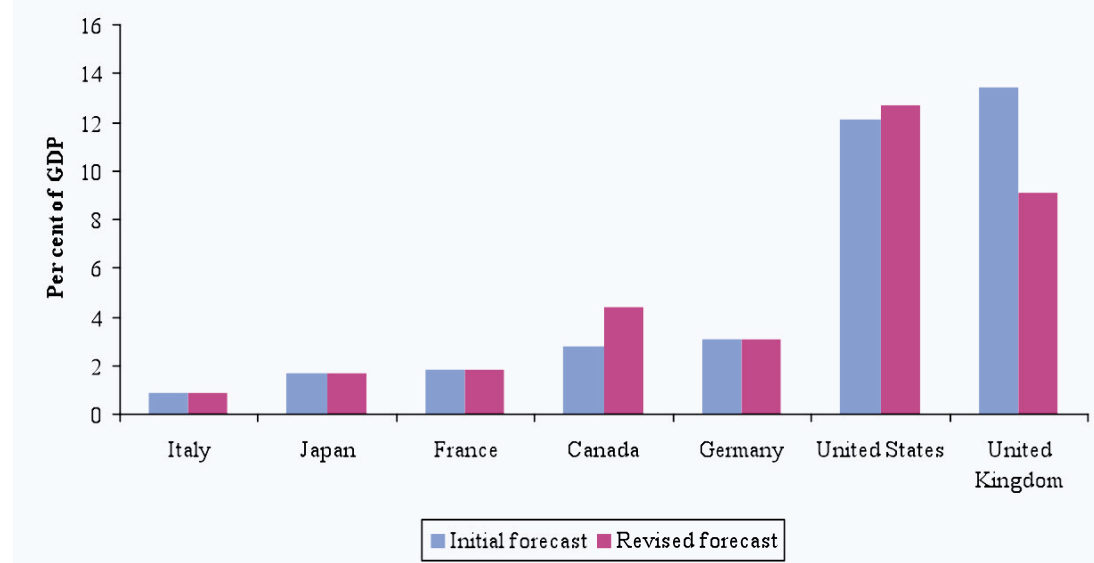
The need for fundamental reform is underlined by the dramatic scale of the disaster we have experienced. The crisis has resulted in taxpayer support for financial institutions on an unprecedented scale. According to the IMF's latest Global Financial Stability Report, central banks in the US, UK and eurozone have provided \$9 trillion of support to the financial sector.

Given the size of the numbers involved we should never forget that this has been a public policy failure of historic proportions. As a result of poor economic management, inadequate regulation and irresponsible risk-taking in a number of banks, the financial sector has inflicted huge costs on the rest of the economy, and is now dependent on taxpayer support for its continuing survival.

The scale of the failure and the resulting costs to taxpayers have been particularly large in Britain. The IMF estimate that the eventual cost to British taxpayers of support for the banking sector will be 9.1% of GDP, or more than £130 billion. That is more than five times the equivalent figure of 1.8% of GDP in France and three times the estimated 3.1% of GDP in Germany.<sup>1</sup> This is hopefully an overestimate, and ultimately the true costs will only be known after many years, but it is already clear that we have placed a heavy burden on future generations. Once the enormous fiscal costs of the consequent recession are included, the full impact on our public finances – already compromised by serious and accumulating structural deficits - will be unprecedented in peacetime, with national debt set to more than double in the space of just five years.

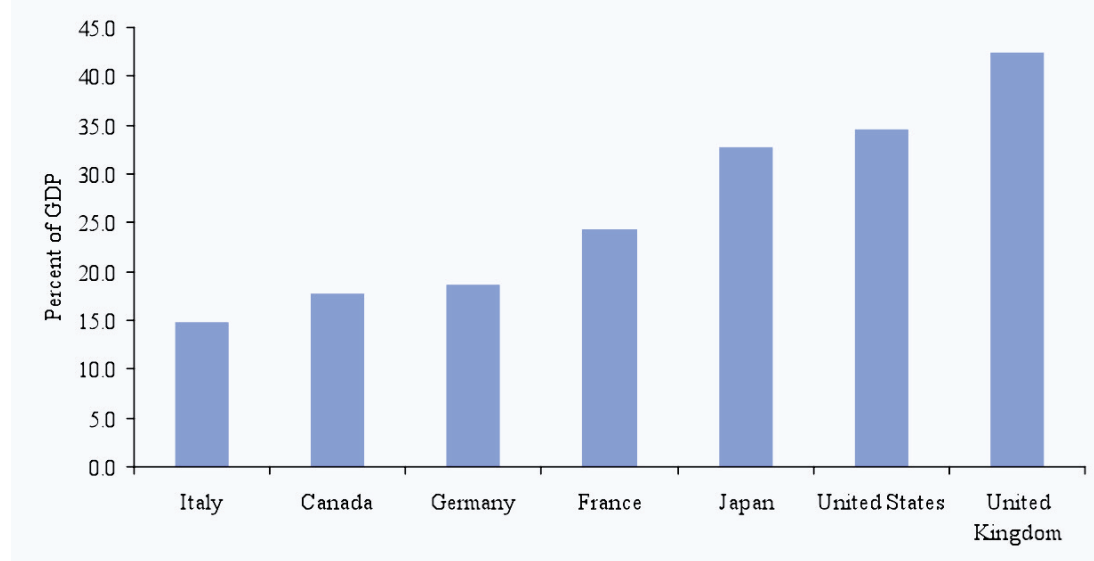
### Financial stabilisation costs

Source: IMF, Global Financial Stability Report, April 2009



### Increase in government debt 2007 - 2010

Source: OECD Economic Outlook No.85, Annex Table 32



The impact is not limited to taxpayers. Wealth has been destroyed across the economy at an astonishing rate. According to the Bank of England “total losses in financial wealth toward the end of 2009 Q1 were equivalent to around 50 per cent of the world’s GDP”.<sup>2</sup> The IMF estimates that the reduction in UK household wealth in 2008 was \$1.5 trillion, equivalent to roughly two thirds of annual economic output. They estimate that the long run impact of these losses could be an increase in the required savings rate of anywhere between 3 and 11 percentage points.<sup>3</sup>

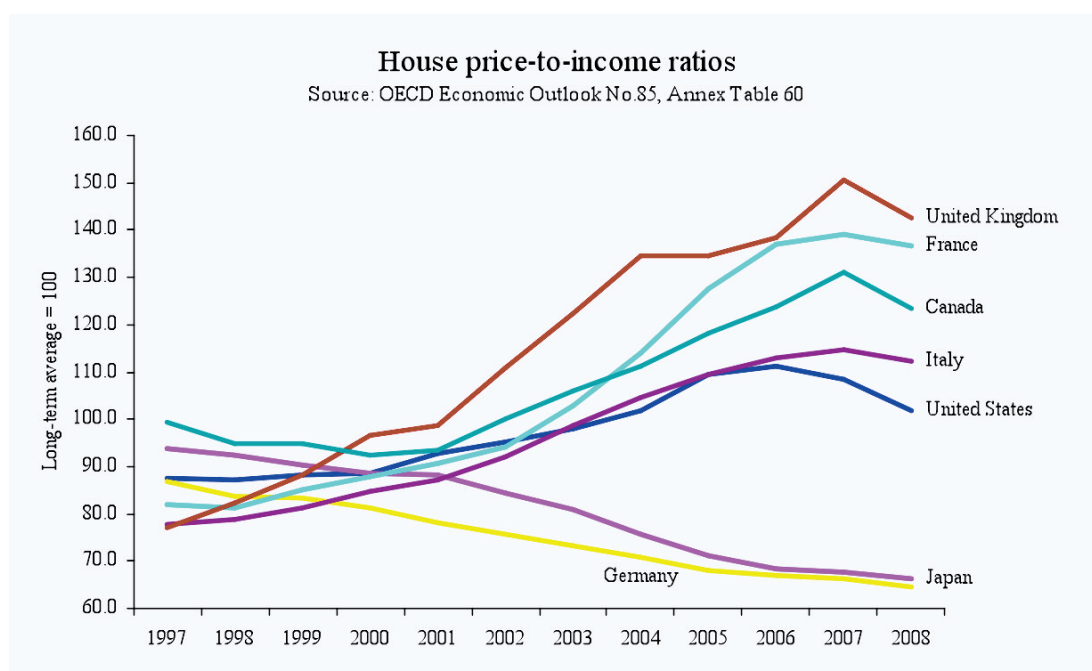
The innocent victims of this policy failure are the many thousands who will lose their jobs or their homes as a result of a severe recession. Unemployment in Britain has risen at record rates, and a whole generation of school and university leavers now face the risk of permanent damage to their working lives if they fail to find a job.

In order to understand what went wrong and why our regulatory system is so badly equipped to identify and respond to future risks, we need to set Britain's domestic policy failures in the context of the underlying macroeconomic imbalances and developments in the financial system.

### *Macroeconomic imbalances*

The international context of the crisis is now widely understood. Persistent macroeconomic imbalances and high rates of saving in surplus countries such as China and Japan created a global environment of low long term interest rates. A huge increase in productivity and supply from newly emerging markets helped to keep inflation low around the world, and central banks that were focused on targeting narrowly defined consumer price stability, including the Bank of England, responded with low policy rates. Interest rates were cut rapidly in order to boost demand following the bursting of the dot-com bubble and were kept at historically low levels around the world during the first part of the decade.

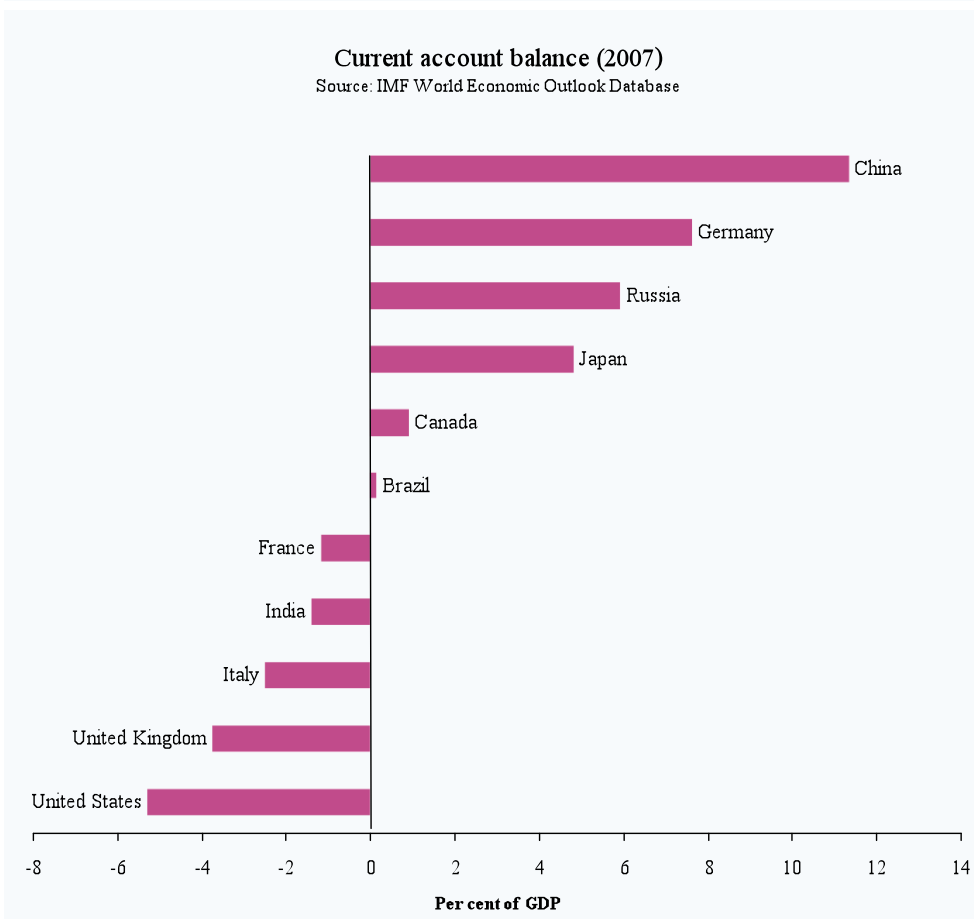
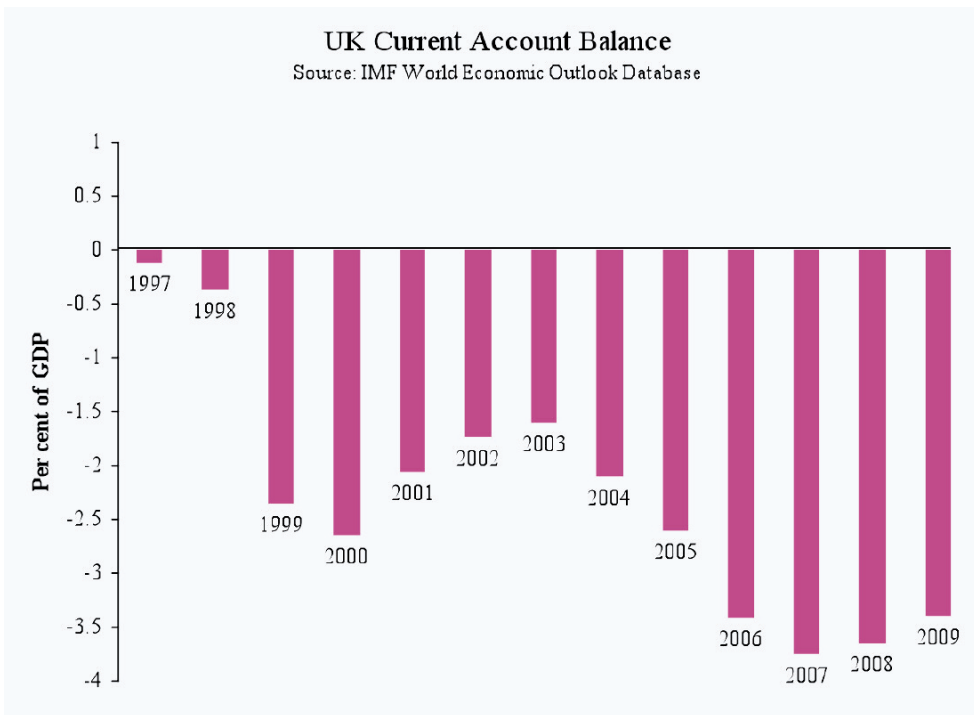
The result was a rapid increase in leverage throughout the system, particularly in Britain where gearing reached unprecedented levels. With consumer prices stable, and narrow inflation expectations anchored by inflation-targeting central banks, the ocean of liquidity was channelled into rapidly rising asset prices, especially housing. Britain's house price boom was the biggest of any major economy.



Set against this global context, a long catalogue of domestic policy failures left the British economy more exposed to the financial crisis than any other major economy. The biggest failures of the British regulatory system stemmed from a fundamental misunderstanding of the deep links between macroeconomic policy and financial stability. This misunderstanding was embodied in Gordon Brown's decision in 1997 to impose a separation between the Bank of England, as the central bank responsible for monetary policy, and the FSA, as the regulatory authority responsible for banking supervision.

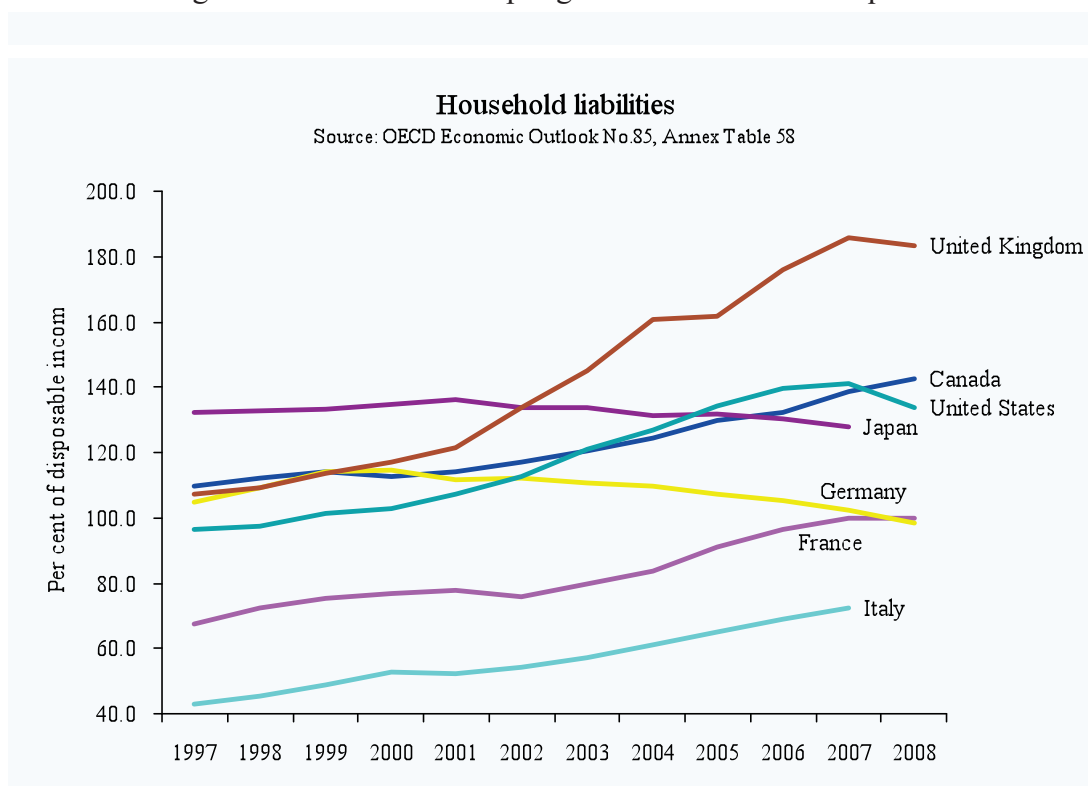
At the core of the link between financial stability and macroeconomic policy are the risks posed by a rapid and unsustainable build up of debt. As George Osborne said back in 2006, *"an economy built on debt is living on borrowed time."*<sup>4</sup> And as David Cameron said in September 2007, just days after the run on Northern Rock, *"the increases in debt in the UK economy – personal, corporate, and Governmental – have added a new risk to economic stability."*<sup>5</sup>

What was identified by the authorities as a decade of stable economic growth was in fact built on an unsustainable mountain of debt. As Professor Ken Rogoff of Harvard University has argued, the telltale macroeconomic signs were all there: a persistent current account deficit financed by huge capital inflows to the banking system, rapid increases in bank and household leverage, historically low savings rates, and soaring house prices.<sup>6</sup> As Lord Turner put it, *“rapid credit extension was underpinned by major and continued macro-imbalances, with the UK – like the US – running a large current account deficit and with domestic credit expansion thus financed at the aggregate level by the willingness of overseas investors to extend credit to UK counterparties”*<sup>7</sup>



These macroeconomic imbalances were actively exacerbated by the Government's fiscal policy. A massive expansion of Government spending after 2001 added to the consumption boom and was financed by rapid increases in public borrowing, much of it from international investors. In addition, changes to the tax and benefit system damaged pensions and undermined incentives to save. When the crisis broke it also revealed the extent of the structural dependence of tax revenues on a narrow and volatile base and exposed the fact that the growth of public spending had been totally unsustainable. When the need arose to bail out failing banks this had to be done against a backdrop of record budget deficits, further undermining confidence in Britain's fiscal position.

The end result was that British banks became amongst the most indebted, most leveraged in the world, with tangible assets 39 times tangible equity compared to only 17 times even in US banks. And by the time the boom turned to bust, our households were the most indebted of any major economy, more even than America's, with debt to income standing at more than 180% for the average British family compared to 140% for the average US family. As Professor Robert Shiller of Yale University has argued, a different policy approach would have identified this debt bubble while it was happening and taken action to reduce its size, instead of waiting until it burst and attempting to deal with the consequences.

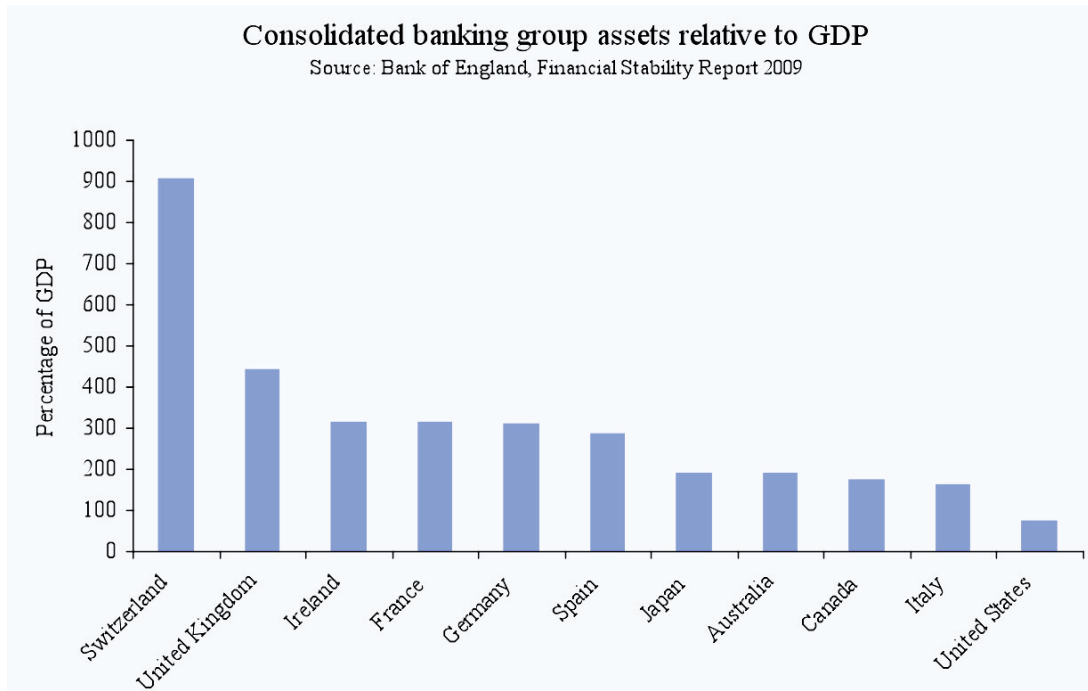


What went wrong in our banks was therefore a reflection of fundamental imbalances that were allowed to build up throughout our economy over a decade. As George Osborne said earlier this year, *“Our banking system is not separate from our economy; it is a reflection of it. Our banks hold a mirror up to the worst excesses of our society. And the unsustainable debts in our banks are a reflection of unsustainable debts in our households, our companies and our Government.”*<sup>8</sup>

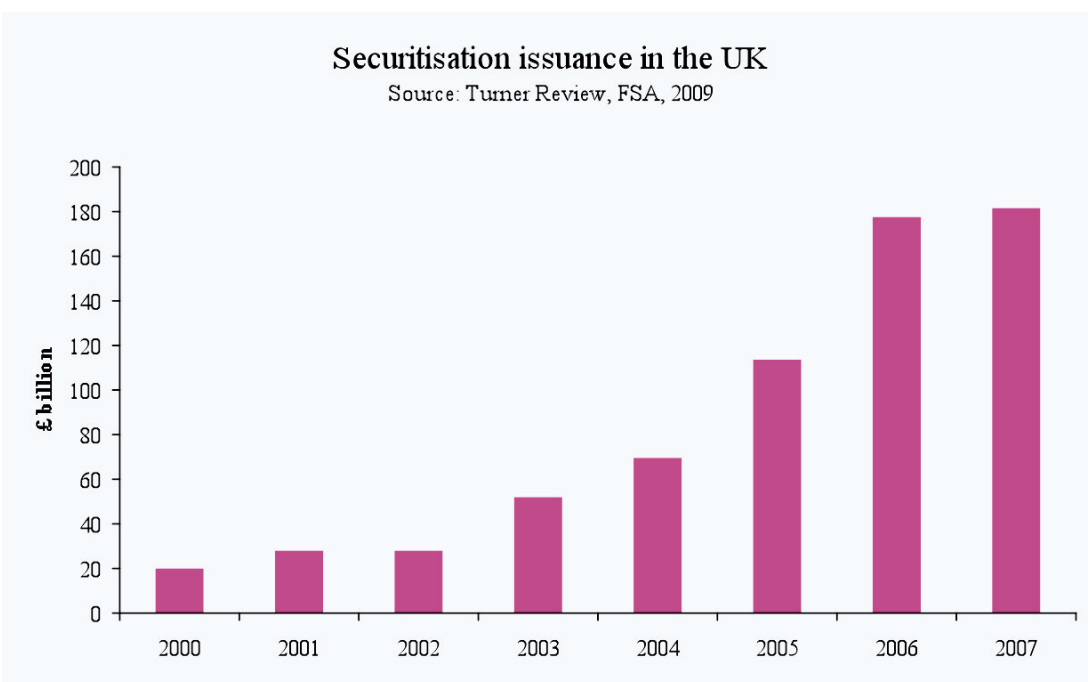
While there are signs that the worst of the banking crisis is now behind us, progress in addressing these underlying macroeconomic imbalances is less clear. The necessary adjustment will take some time and in the longer term will require extensive microeconomic reforms to encourage consumer spending in surplus countries and structurally higher rates of saving in deficit countries such as Britain.

## The Financial Sector

Macroeconomic imbalances interacted with new developments in the financial sector to spread risk throughout the economy. As a global financial centre, Britain's economy is particularly dependent on a successful financial sector. The financial services industry will continue to be an important source of job creation and tax revenues but as a result the British economy is extremely vulnerable to poor regulation and financial instability.



Internationally the flow of savings from surplus countries triggered an increasingly desperate search for yield, with investors taking on more risks in exchange for higher returns. This demand was met by the development of new financial instruments, especially asset backed securities (ABS) created by banks from loans against residential and commercial property, commercial and consumer credit. Investors and regulators were reassured by the supposedly solid, triple-A ratings given by credit rating agencies to some of the Collateralised Debt Obligations (CDOs) and other securitised instruments created by the banks. British banks were particularly active in these markets and some became dangerously dependent on these new instruments for revenue and profit growth. The result was a dangerous increase in leverage that the regulatory system failed to identify as a potential risk or take action to prevent.



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Many investments were made through off balance sheet vehicles designed to minimise the amount of regulatory capital the banks needed to put aside in case the loans turned bad. In retrospect, it is clear that the design and sale of these products was driven by a combination of regulatory arbitrage, reckless bonus structures and the perverse incentives of the rating agencies which encouraged favourable ratings.

While the conventional wisdom was that the new financial innovations had helped to disperse and diversify risk, the reality was that the system as a whole became hugely risky in aggregate. The pricing and credit ratings of many of the complex financial products on banks' balance sheets were derived from backwards looking mathematical models based on relatively short and recent time periods of data. In particular, most of the models assumed that average house prices would never fall by significant amounts.

As Hyman Minsky has argued, long periods of stability tend to be associated with speculative bubbles and the build of large risks in financial markets. At some point these bubbles burst and the process goes into reverse with catastrophic results. In this case the trigger for the "Minsky moment" was a reassessment of prospects for the US subprime mortgage market, although the risks in the system were global and extended far beyond subprime.

When US house prices began to fall and levels of delinquencies in sub-prime mortgage lending began to rise, investors rapidly became nervous about the true values of all of the complex products on their balance sheets. From a British point of view, even though the trigger was pulled in the US, the gun had been loaded at home through a massive increase in debt in the banking system and throughout the economy. Eventually the credit markets froze up completely as investors lost confidence in a whole class of financial products and the institutions that had bought them.

The resulting collapse of financial institutions is well documented. As losses mounted, trust in the liquidity and subsequently in the solvency of major banks and other financial institutions evaporated, culminating in the run on Northern Rock in the UK and eventually the catastrophic collapse of Lehman Brothers in the US. This triggered what was in effect a run on the entire banking system, laying bare the interconnected nature of the global financial system. The full impact of this financial heart attack on the rest of the global economy is only now becoming clear.

### ***Regulatory Failure***

These macroeconomic and financial developments were combined with a massive failure of regulation. The regulatory framework failed to ensure that banks had enough capital to insure against the risks of loans going bad, allowed banks to hide risks off their balance sheets, essentially ignored the issue of liquidity, and exacerbated the credit cycle by making lending cheaper during the boom and more expensive when the market turned.

In Britain these failings were exacerbated by confused and inadequate domestic regulation. The tripartite regulatory system that Gordon Brown created in 1997 was both ill-conceived and badly executed. It was put in place with little consultation and against the advice of the then Governor of the Bank of England, the late Lord George. It was also opposed at the time by the Conservative Party. Peter Lilley, then the Shadow Chancellor, warned the House of Commons that "*with the removal of banking control to the Financial Services Authority – the 'super-SIB' – it is difficult to see how and whether the Bank remains, as it surely must, responsible for ensuring the liquidity of the banking system and preventing systemic collapse.*"<sup>9</sup>

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The most important flaw in the British regulatory system was that nobody was responsible for putting together all the different warning signals and acting on them. The tripartite structure was based on a false premise: that it was sensible to separate monetary policy in one institution and the regulation of banks' balance sheets through which monetary policy operates in another. As a result responsibility was split between a monetary authority with no powers over the banks and a bank regulator with no remit to monitor the bigger picture. The tripartite structure, which was supposed to knit the two parts together, proved to be wholly ineffective at achieving this. Given what we now understand about the risks posed by financial imbalances to economic stability, this structure is fundamentally unsuited to future challenges.

In the decade following its independence in 1997, the Bank of England was mainly concerned with using short term interest rates to meet the inflation target. Other macroeconomic variables, such as the rapid increase in bank and household balance sheets, soaring house prices, or the persistent current account deficit, were only relevant to this task to the extent that they influenced consumer price inflation. Unfortunately, it is now clear that stable consumer price inflation is not a sufficient condition for economic stability.

The Bank's narrow focus was exacerbated by two further changes. First, in order to be consistent with the measure of inflation used in the eurozone, Gordon Brown changed the inflation target in 2003 from retail price inflation, which includes housing costs, to the consumer price index, which does not. This meant that monetary policy took even less account of the credit fuelled boom in house prices. As the Governor of the Bank himself has said, "*it would have been preferable had we stayed with an index in which House prices were still included.*"<sup>10</sup>

Second, the Bank of England reduced the regularity and intensity of its engagement with financial markets and downgraded its role in monitoring financial institutions because this was within the powers of the FSA. The Bank did continue to warn about some of the problems in its twice yearly Financial Stability Report, but given its narrow powers it was unable to translate warnings into action.

The limited focus of the Bank of England was compounded by the narrow approach taken by the Financial Services Authority to the job of regulating the financial sector. The FSA was formally responsible for both prudential supervision of the risks that banks were taking and regulation of the way banks went about their business both internally and in their dealings with customers. In practice the former was downgraded in favour of the latter, resulting in a box-ticking approach to ensuring compliance with detailed rules. As Lord Turner has said, "*we focused too much on the conduct of business and not enough on prudential*".<sup>10</sup> Given the greater immediate political pressure associated with short term failures of consumer-facing regulation than with prudential supervision of longer term risks, the danger is that prudential supervision will be downgraded within any organisation that is also responsible for consumer protection.

As a consequence the FSA failed to spot or prevent a dangerous build up of risk throughout the banking system. Without the economy-wide understanding of a central bank, sufficient market expertise or the authority that comes with being the lender of last resort, the FSA was unable to challenge senior management over their unsustainable business models or risky remuneration structures. The end result was a banking sector that was undercapitalised, dependent on unsustainable funding strategies, low on liquid assets, poorly governed by weak boards and driven by dangerously short term incentives.

As well as being fundamentally ill-conceived, the creation of the tripartite system was badly executed. When the crisis broke, the run on Northern Rock exposed a failure of coordination between the three tripartite authorities and a lack of effective procedures for dealing with failing banks. This was despite the fact that simulations in 2004 had exposed these weaknesses and Ministers had been informed of the need for new powers.

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The tripartite system has also failed to protect consumers of financial services. The corollary of the unsustainable business models pursued by several British banks was aggressive marketing of risky and often unsuitable financial products. In part this resulted from the FSA's failure to challenge the industry. Many of those who were encouraged to borrow more than they could realistically afford now find themselves in the misery of negative equity or burdened with heavy repayments. Northern Rock's 125% "Together" mortgages were not just a failure of prudential regulation; for many consumers they have become a source of significant hardship.

In the past few years there have also been numerous examples of unfair treatment of consumers – from aggressive marketing of unsuitable products to the mis-selling of payment protection insurance and unfair bank charges. This unfair treatment of consumers has continued as the crisis has progressed. As taxpayers they are funding the bank bail-outs, as savers they are facing extraordinarily low interest rates, and even responsible borrowers are finding credit lines withdrawn and a sharp increase in credit charges.

In the wake of the crisis financial services consumers may find themselves more vulnerable. Mergers in the sector have narrowed competition in what was an already concentrated market. And there is a danger that, as banks rebuild their balance sheets, retail and small business charges may be seen as an easy means of boosting revenue.

The senior management of the FSA have been commendably open about the failures of the tripartite structure in their own review of what went wrong. The FSA's own report on Northern Rock stated that *"some of the fundamentals of work on assessing risks in firms (notably some of the core elements related to prudential supervision, such as liquidity) have been squeezed out"*.<sup>12</sup> The problem with the existing arrangements is not the people at the FSA, many of whom are very good, but the inherent problems created by the current structure. Despite their efforts to improve the FSA's operations since the beginning of the crisis, the FSA's management remain limited in what can be achieved as long as the flawed tripartite structure remains in place.

Coordination between the different parts of the system remains poor. It is shocking that the Governor of the Bank of England was not shown a copy of the Government's recent White Paper on financial regulation until just days before it was published. And the open disagreement between the lead actors on how the system should be reformed has undermined the potential for a strong British voice in the global regulatory debate.

In summary, Gordon Brown made five crucial errors in macroeconomic policy and financial policy as Chancellor: creating the flawed tripartite structure; removing the Bank of England's historic role of calling time on the levels of credit and debt in the economy; removing housing costs from the inflation target; running an increasingly unsustainable fiscal policy; and consistently ignoring warnings on the risks building up throughout the financial system.

## Box 1: The case against the tripartite structure – third party evidence

### ***The failure of macro-prudential regulation***

“The Bank of England appears to have devoted fewer resources to macro-prudential matters relating to financial stability in the period leading up to the financial crisis.” *House of Lords Select Committee on Economic Affairs, Banking Supervision and Regulation, June 2009*

On macro-prudential analysis and policy in the UK: “The failure to do this analysis and to take action on it was one of the crucial failures of the years running up to the financial crisis.” *The Turner Review, 18th March 2009*

The Sassoon Review pointed out that after dropping its third core purpose, relating to the efficiency and effectiveness of the financial system, in 2004 the Bank was “lessening its engagement with the markets in the immediate run-up to the financial crisis”. *Sir James Sassoon, The Tripartite Review; Preliminary Report, March 2009*

### ***The Bank’s written warnings about imbalances were ignored***

“We did spot some crazy borrowing going on, asset prices looking unsustainable and we said actually for a couple of years before the crash that a correction was coming.” *Sir John Gieve, BBC interview, December 2008*

“Strong and stable macroeconomic and financial conditions have encouraged financial institutions to expand further their business activities and to extend their risk-taking, including through leveraged corporate lending, and the compensation for bearing credit risk is at very low levels”, *Bank of England’s Financial Stability Report, April 2007*

“[Some] aspects of the global economy look unsustainable, particularly the pattern of global current account imbalances and the low level of real interest rates and risk premia. So the macroeconomic context is likely to be somewhat less benign [in the next ten years]” *Bank of England’s written evidence to Treasury Select Committee, February 2007*

“The questions are whether risk is being priced properly, and to what extent the search for yield is leading to excessive leverage”, *Bank of England’s Financial Stability Review, December 2004*

### ***Failure to coordinate in a crisis***

“[The tripartite system] may be a Rolls Royce when it sits on the shelf, turns into an old banger when it gets on the ground.” *John McFall MP, Chairman of the Treasury Select Committee, 25 Sep 2007*

“the tripartite authorities in the United Kingdom (the Bank of England, Financial Services Authority (FSA) and Treasury) failed to maintain financial stability and were found wanting in dealing with the crisis, in part because the roles of the three parties were not well enough defined and it was not clear who was in charge.” *House of Lords Select Committee on Economic Affairs, Banking Supervision and Regulation, 2 June 2009*

“On occasions it [the tripartite system] functioned with jawdropping incompetence and chaos. It was astonishing how badly their system worked...in the present tripartite structure it is clear that nobody was actually in charge...So we do need to have a modification in the tripartite system where someone is clearly in charge from the beginning” *Professor Geoffrey Wood, Evidence to the House of Lords Select Committee on Economic Affairs, Q 48*

“When we questioned the Tripartite authorities as to who was in charge, the Governor’s first reply was “What do you mean by ‘in charge’? Would you like to define that?”” *Treasury Select Committee, The run on the Rock, January 2008*

“we are concerned that, to outside observers, the Tripartite authorities did not seem to have a clear leadership structure” *Treasury Select Committee, The run on the Rock, January 2008*

“There was insufficient clarity in the allocation of roles, responsibilities and authority among the Tripartite authorities and no one entity had clear power to take the lead.” *British Bankers Association, Memorandum to the Treasury Select Committee, November 2007*

### ***The failure of prudential supervision***

“the FSA concentrated on its responsibility for conduct-of-business supervision (concerned mainly with consumer protection) and did not pay full attention to micro-prudential supervision (the solvency and sustainability of individual banks)” *House of Lords Select Committee on Economic Affairs, Banking Supervision and Regulation, 2 June 2009*

“we focused too much on the conduct of business and not enough on prudential [regulation]”. *Lord Turner, evidence to the House of Lords Select Committee on Economic Affairs, Banking Supervision and Regulation, June 2009*

The Government’s own White Paper concluded that “too much weight had been placed” on “ensuring that systems and processes were correctly defined rather than on challenging business models and strategies” and on “conduct of business regulation of the banking sector rather than prudential regulation of banking institutions”. *HMT, Reforming Financial Markets, July 2009, page 56*

“There is also a cultural difference between conduct-of-business and prudential supervision. Conduct-of business supervision is often done by lawyers. Prudential supervision is largely an economic activity, particularly at the macro-level. It seems likely that either a lawyerly or an economic approach would dominate in a supervisory body that conducted both prudential and conduct of business supervision, and that this dominance would reduce the effectiveness of the dominate half of the organisation.” *House of Lords Select Committee on Economic Affairs, Banking Supervision and Regulation, June 2009, p33*

“The skills and mindset required to operate as a consumer protection regulator is fundamentally different from those required by a systemic regulator. Protecting consumers involve setting and then enforcing the appropriate rules under a transparent legal framework. The orientation of an effective systemic regulator must be different from that of a rule-enforcing consumer protection or conduct of business regulator. A regulator charged with both enforcing rules and managing systemic risk may end up devoting too much of its attention to rule enforcement.” *Frederic Mishkin, Testimony to United States House of Representatives Subcommittee on Domestic Monetary Policy and Technology, July 9<sup>th</sup> 2009*

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## Part 2: A strong and powerful Bank of England

Given the broad scope and massive scale of these regulatory failures, we need fundamental reform of our regulatory system. Carrying on much as we did before is not an option. That is why in the autumn of 2008 the Conservative Party commissioned Sir James Sassoon, formerly a Managing Director at the Treasury, to conduct a review of the failed tripartite system.

Credible and effective regulation is not just necessary to protect economic stability, it is also vital to the future success of Britain's financial services sector. London will not survive as a competitive global financial centre unless its regulatory system is respected around the world.

There is an emerging international consensus on many of the solutions that are required to prevent a crisis of this magnitude happening again. These include:

- Increasing the quality and quantity of bank capital
- Increasing capital requirements for risky trading activities
- Introducing limits on banks' leverage
- Improving the regulatory focus on liquidity
- Regulating risky remuneration structures

Many of these reforms will require international agreement on new rules to govern banks' international operations and will depend on new forums for international coordination. But the experience of the last decade suggests that no system of rules will ever be enough in itself to prevent another crisis. Indeed the origins of this crisis lie partly in the strategies developed by market participants to find ways around international rules.

We need an understanding of the limitations of rules if we are to avoid sowing the seeds of the next crisis in the solutions to this one. In particular, as George Osborne said in April this year, "*where strong regulation is needed – as in financial markets – rules must be supplemented by powerful institutions who are empowered to use their discretion when necessary.*"<sup>13</sup>

Building those powerful institutions must be at the heart of any credible programme of regulatory reform.

### ***The Government's proposals***

The Government has put forward their proposed method of meeting the critical challenge of ensuring financial stability. Their proposals amount to a confused system that entrenches the failed tripartite structure, splits responsibilities between different institutions, and does not provide the necessary powers.

- In the 2009 Banking Act the Government gave the Bank of England statutory responsibility for financial stability and created a new "financial stability committee".
- They are now proposing in addition to give the FSA a formal, statutory objective for financial stability.
- On top of this they propose a new Council for Financial Stability – whose membership simply reflects the tripartite arrangement – as a third body with responsibility for protecting financial stability.

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These reforms merely reinforce the poor coordination that has characterised the tripartite structure. They do not provide any additional protection for financial stability because the Government has failed to give the Bank any “macro-prudential tools” or powers to take action when it is required. Despite the 2009 Act and the recent White Paper, the Bank remains essentially in the position it was in before the crisis: it can issue warnings, but no more. The Government’s White Paper confirms that the most significant feature of the Bank’s role *“is to analyse and warn of emerging risks to financial stability in the UK, principally by means of its Financial Stability Report.”*<sup>14</sup>

This is patently inadequate – the Bank issued repeated warnings in the run-up to this crisis but without effect. As the Governor of the Bank has argued *“Warnings are unlikely to be effective when people are being asked to change behaviour which seems to them to be highly profitable. So it is not entirely clear how the Bank will be able to discharge its new statutory responsibility if we can do no more than issue sermons”*<sup>15</sup>.

The Government’s proposed Financial Stability Committee reflects the confusion over whether the Bank’s new statutory responsibility is matched with any expectation of executive action. Under the Government’s plans it will simply be a sub-committee of the Court of Directors of the Bank with a remit to advise the Court on the Bank’s financial stability strategy.

As the Treasury Select Committee concluded, *“we do not believe that a Financial Stability Committee which is constituted as a Sub-Committee of the Court and is thus inhibited from assuming decision-making authority will significantly enhance the credibility, authority or efficiency of the performance of the Bank’s financial stability functions.”*<sup>16</sup>

The Government’s new Council for Financial Stability simply replaces the existing tripartite standing committee and therefore offers no new leadership or accountability on financial stability.

### ***The Conservative solution***

**We will abolish the FSA and the failed tripartite system and create a strong and powerful Bank of England with the authority and powers to protect financial stability.**

- **The Bank of England will be responsible for macro-prudential regulation, judging and controlling risks to the financial system as a whole. This will restore the Bank’s historic role in monitoring the overall level of credit and debt in the economy, and builds on existing Conservative proposals for a Debt Responsibility Mechanism.**
- **This macro-prudential role will be carried out by a new Financial Policy Committee within the Bank, working alongside the Monetary Policy Committee, which will monitor systemic risks, operate macro-prudential regulatory tools and execute the special resolution regime for failing banks.**
- **The Financial Policy Committee will include independent members in order to bring external expertise to bear on the problem of maintaining financial stability. It will include the Governor and the existing Deputy Governor for Financial Stability, who also sit on the Monetary Policy Committee, in order to ensure close coordination between monetary and financial policy.**
- **The Bank will also be responsible for the micro-prudential regulation of all banks, building societies and other significant institutions, including insurance companies.**

- **This micro-prudential role will be carried out by a new Financial Regulation Division of the Bank, headed by a new Deputy Governor for Financial Regulation, who will also be a member of the Financial Policy Committee.**
- **The work of the Financial Regulation Division will be overseen by the Financial Policy Committee to ensure close coordination between macro-prudential and micro-prudential regulation.**
- **We will create a strong new Consumer Protection Agency with responsibility for protecting consumers. This will create a new framework and culture for financial services consumer protection regulation.**
- **We will simplify the system by moving responsibility for consumer credit regulation from the Office of Fair Trading to the Consumer Protection Agency, reducing the number of overlapping regulators responsible for consumer protection.**

Giving these additional responsibilities and powers to the Bank of England creates a single point of accountability for financial stability. It will bring together market and institutional insight in one authority and ensure that the tools for preserving stability are operated in concert.

## **Box 2: The case for fundamental reform – third party evidence**

### ***The case for locating micro-prudential supervision in the central bank***

“combining the two responsibilities within the central bank does have certain practical advantages. Central banks need a great deal of information about banks’ balance sheets and behaviour, in relation to their monetary policy responsibilities - money is after all uniquely a liability of the banking system. And they clearly also need such information in relation to their responsibility for maintaining systemic financial stability - where banks remain of special importance because their balance sheets are still typically dominated by highly liquid deposits financing less liquid assets, which makes banks especially vulnerable to a rush for the exit if there is a loss of confidence.”  
*Eddie George, Mansion House Speech, Thursday 12 June 1997*

“The Federal Reserve’s role in banking supervision complements its other responsibilities, especially its role in managing financial crises... During the current crisis, supervisory expertise and information have repeatedly proved invaluable in helping us to address potential systemic risks involving specific financial institutions and markets and to effectively fulfil our role as lender of last resort... The Fed’s prudential supervision benefits, in turn, from the expertise we develop in carrying out other parts of our mission – for example, the knowledge of financial and economic conditions we gather in the formulation of monetary policy” *Ben Bernanke, Lessons of the Financial Crisis for Banking Supervision, May 2009*

“The information, expertises, and powers that the Fed derives from its supervisory authority enhance its ability to contribute to efforts to prevent financial crises; and, when financial stresses emerge and public action is warranted, the Fed is able to respond more quickly, more effectively, and in a more informed way that would otherwise be possible”. *Ben Bernanke, Central Banking and Bank Supervision in the United States, January 2007*

“Indeed, one of the main lessons of the crisis may be that those countries where Central Banks assume banking supervision took advantage of their ability to react quickly and flexibly to emergency situations.” *Christian Noyer, Governor of the Banque de France, Speech on 3 July 2009*

“in managing the current crisis we have gained enormously from having the banking supervisor at the table with us throughout, playing an integral part in every discussion, with all the data as needed. Those who have not worked in bureaucracies might argue that all this can be achieved through better coordination. The world does not work that way. Information flows between organizations are simply less efficient than those within organizations. Decision-making that has to be coordinated between organizations is slower and less clear-cut than when the decisions are made within a single organization. It is very likely that prudential supervision will return to central banks when the lessons of this crisis are drawn.” *Stanley Fischer, Governor of the Bank of Israel and Former Chief Economist at the World Bank, Speech on 8 November 2008*

“There are four reasons why I believe that the Federal Reserve should be made the systemic regulator of financial markets in the United States. First, the Federal Reserve has daily trading relationships with market participants as part of its core function of implementing monetary policy and is well placed to monitor market events and to flag looming problems in the financial system...Second, the Federal Reserve’s mandate to preserve macroeconomic stability is well matched to the role of ensuring the stability of the financial system...Third, the Federal Reserve is among the most independent of government agencies. Successful systemic regulation requires a focus on the long run... Fourth, the Federal Reserve is the lender of last resort. It has a balance sheet that it can use as a tool to meet systemic financial crises. As the lender of last resort, it will be called on to provide emergency funding in times of crisis.” *Frederic Mishkin, former member of the Board of Governors of the Federal Reserve, Testimony to United States House of Representatives Subcommittee on Domestic Monetary Policy and Technology, July 9<sup>th</sup> 2009*

### ***The inadequacy of the Government’s plans***

“Warnings are unlikely to be effective when people are being asked to change behaviour which seems to them to be highly profitable. So it is not entirely clear how the Bank will be able to discharge its new statutory responsibility if we can do no more than issue sermons”. *Mervyn King, Mansion House Speech, 17<sup>th</sup> June 2009*

“We were given a statutory responsibility for financial stability in the Banking Act, and the question I put to you in February at this committee, to which I have not really received any adequate answer from anywhere, was: what exactly is it that people expect the Bank of England to do? All we can do at present, before a bank is deemed by the FSA to have failed, is to write our financial stability report and give speeches.” *Mervyn King in evidence to Treasury Select Committee, 24th June*

There is “a danger that [the government’s proposed financial stability committee] will lack focus and be ineffective”. *House of Lords Select Committee on Economic Affairs, Banking Supervision and Regulation, June 2009*

“Without a clear executive role, the Bank can do no more than talk about financial stability. This exposes it to reputational risk, without generating clear benefit.” *House of Lords Select Committee on Economic Affairs, Banking Supervision and Regulation, 2 June 2009*

“The Committee recommends that the Government should as a matter of priority revisit the tripartite supervisory structure in the United Kingdom” *House of Lords Select Committee on Economic Affairs, Banking Supervision and Regulation, 2 June 2009*

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One of the most important lessons of the crisis is that stable consumer price inflation is not a sufficient condition for economic stability. In order to bolster the ‘one target one instrument’ strengths of the inflation targeting framework, the Bank of England needs a second instrument – macro-prudential regulation – to target financial stability over the economic cycle. This was one of the key conclusions of the Sassoon Review.

The analysis in Section 1 explained why the deep links between monetary policy and financial stability strongly suggest that the same institution should be responsible for both.

A further argument justifies the location of responsibility for financial stability in an independent central bank – the same ‘time consistency’ problem that applies to monetary policy applies to financial stability. In other words, since both require the punch bowl to be taken away before the party gets out of hand, politicians subject to the pressures of electoral cycles cannot always credibly maintain that they will always ignore short term political pressures for looser policy – whether in the form of lower interest rates or easier capital regulation.

The operation of macro-prudential regulation should therefore be delegated to an independent central bank, with a clear mandate provided by democratically elected politicians. Just as with conventional monetary policy, the independent central bank will then be able to build up credibility in controlling credit expansion and maintaining financial stability. And the impact of that credibility on market expectations will itself make it easier for the central bank to carry out their mandate.

The analysis in Section 1 also provides several strong reasons for co-locating micro-prudential supervision of individual institutions with macro-prudential supervision within the central bank.

- As the lender of last resort, the Bank of England should also have responsibility for financial regulation. This will ensure that the Bank has a full understanding of any bank that gets into trouble. Never again do we want to end up with a system where prudential regulation and central bank intervention is so out of step.
- Macro policies can affect the supervision of individual banks and institutions. For example, recognition of the UK financial system’s exposure to wholesale funding markets at a macro level would have enabled bank supervisors to identify the risks borne by specific banks and take pre-emptive action more quickly.
- Micro-prudential regulation can inform macro-prudential risk analysis. For example, if it is found that the exposure of many banks to a particular sector has increased rapidly, this information can be picked up by the financial stability side of the Bank as a warning signal that a potential bubble may be building up.
- History has shown that the model of integrated prudential and consumer regulator leads to a focus on consumer protection at the expense of prudential supervision. In the run-up to the financial crisis, prudential regulation in the UK was marginalised by the FSA. Consumer protection regulation requires a more legalistic mindset, whereas micro-prudential regulation must be rooted in economic and financial judgements. We need micro-prudential regulators who are able to scrutinise and challenge senior executives on, for example, their appetite for risk.

By giving responsibility for micro-prudential regulation to the Bank of England we will ensure that micro-prudential regulation is geared towards financial stability and embedded in an organisation with the culture of making decisions based on judgement, rather than process. It will also end any confusion over accountability in a crisis by creating one regulator with overall and final responsibility for financial stability.

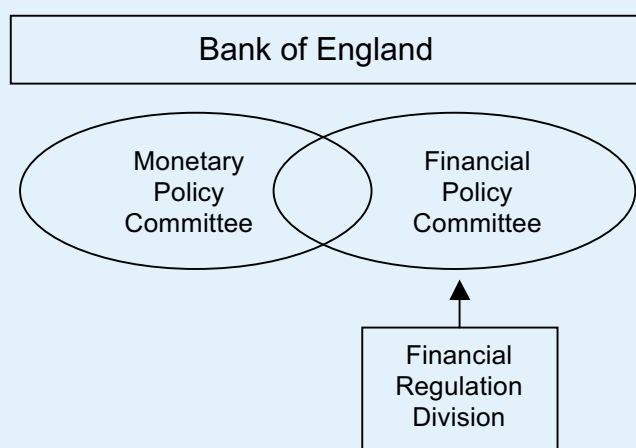
At the same time, a dedicated Consumer Protection Agency will bring a new focus to consumer protection regulation.

### Box 3: The new structure of the Bank of England

The structure of the Bank needs to change to reflect its new responsibilities. The new structure of the Bank of England will ensure that monetary policy, financial stability and the regulation of individual institutions are closely coordinated.

Given the Bank's broader range of responsibilities, the new structure will also reduce the institutional reliance on the position of Governor, with a collegiate approach to policy on financial stability and more use of external expertise. This will build on the collective responsibility model of the Monetary Policy Committee, which also includes external members.

Under our plans the remit and membership of the Monetary Policy Committee (MPC) would remain unchanged.



A new Financial Policy Committee (FPC) would be responsible for the overall stability of the financial system, for triggering and operating the special resolution regime, and for operating macro-prudential regulation. The Financial Policy Committee would also oversee the work of the Financial Regulation Division and would ensure that there is full co-ordination with the new Consumer Protection Agency.

The FPC's members would include at least the Governor and the Deputy Governor for Financial Stability who also sit on the MPC, ensuring coordination between the two committees. It would also include independent external members, the Chief Executive of the new Consumer Protection Agency and the new Deputy Governor for Financial Regulation who would manage the day to day operation of the new Financial Regulation Division responsible for supervising individual institutions.

The Court of the Bank would remain responsible for the overall management of the Bank and its resources.

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## *The Monetary Policy Committee*

**We are fully committed to an independent Bank of England with a mandate to set interest rates to target inflation. We do not believe that the Monetary Policy Committee’s mandate should change as a result of the Bank’s new responsibilities for protecting financial stability or supervising financial institutions. However, as we have argued for more than three years, the procedures for advertising and approving external appointments to the MPC should be made more transparent to match the procedures for other public appointments.**

One of the key strengths of the current inflation targeting regime in normal conditions is that one instrument – the short term interest rate – is used to target one variable – inflation. Changing the inflation targeting regime to take account of financial stability concerns would risk destabilising the economy without materially improving the stability of the financial system.

We agree with the Governor of the Bank that *“to argue that monetary policy should be directed to counter inadequately priced risk is to argue that unemployment is a price worth paying to tame the banking system”*<sup>17</sup>. Interest rates are a blunt instrument for targeting the credit cycle. Therefore under a Conservative Government the Monetary Policy Committee would retain its current mandate and operational independence. We would not give the MPC new macro-prudential objectives.

However, monetary policymaking may be further strengthened through changes to the price index which the Bank uses as its benchmark for inflation. In 2003 Gordon Brown changed the inflation target from RPIX, which included housing costs, to the current CPI target, which does not. The exclusion of housing costs from the target means that it does not reflect consumers’ true cost of living.

The Governor of the Bank is among those who has argued that this change has been detrimental to financial stability: *“Certainly in the last two or three years, before the crisis began in 2007, it is fair to say that the change in the target probably made it more difficult for us to achieve that balance... I think it would have been preferable had we stayed with an index in which house prices were still included.”*<sup>18</sup>

**Given the fragility and uncertainty in financial markets, any change to the measure of inflation should be carried out in a careful and considered way, with extensive consultation. We will conduct a review in government, involving the Governor of the Bank of England, to consider what changes would be appropriate.**

## *The Financial Policy Committee*

**We will create the Financial Policy Committee (FPC) as an executive committee within the Bank of England, similar to the Monetary Policy Committee. It will be given a clear mandate by the Chancellor for monitoring and limiting the systemic risks posed by the financial system as a whole.**

The FPC will operate a series of macro-prudential tools in order to reduce the risks to financial stability across the financial system. Many of these macro-prudential tools will be developed and negotiated at an international level. They are discussed in more detail in Section 3. Ultimately a globally coordinated regime is imperative, but in its absence we will need domestic protections to preserve the UK’s financial stability in the years ahead.

The FPC’s members will include at least the Governor and the Deputy Governor for Financial Stability who also sit on the MPC, ensuring coordination between the two committees. It will also include independent external members, the Chief Executive of the new Consumer Protection Agency and the new Deputy Governor for Financial Regulation. The external members will be appointed through the same transparent process as the external members of the MPC.

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As is the case with the MPC, the FPC will act under a formal remit from the Chancellor. It will be held accountable through a regular exchange of public letters between the FPC and the Chancellor. Like the MPC, its performance and procedures will be reviewed by the Court of the Bank on an ongoing basis, and it will be accountable to Parliament through regular reports and evidence given to the Treasury Select Committee.

Finally, through the publication of the minutes of its meetings and the Financial Stability Report, the FPC will be accountable to the public at large. Any publications would exclude commercially sensitive information about individual institutions.

This approach of restoring the Bank of England's historic responsibility for the overall level of credit and debt in the economy builds on the Debt Responsibility Mechanism proposed by the Conservative Party in 2008.

#### **Box 4: Plans for reform in the United States**

In the United States President Obama is proposing significant reforms to the US regulatory system. He has described his plans as “*a sweeping overhaul of the financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression.*”<sup>19</sup> The regulatory agencies shown to be inadequate in either averting or handling the financial crisis will be reformed or replaced.

The Administration's aim is to “*create a framework in which markets can function freely and fairly, without the fragility in which normal business cycles suddenly bring the risk of financial collapse*” and to create a system that works for businesses and consumers.<sup>20</sup>

Their plans include:

- Giving the Federal Reserve new authority for regulating bank holding companies and other large systemically important firms that pose a risk to the entire economy in the event of failure.
- Requiring systemically important firms to meet stronger capital and liquidity requirements so that they are more resilient and less likely to fail.
- Creating a new Consumer Financial Protection Agency to ensure that there is a regulatory agency whose primary concern is protecting individuals.
- Pushing for international co-ordination on supervision of large global companies and international reforms on capital requirements.

#### ***The Bank of England's new Financial Regulation Division***

**A Conservative Government will make the Bank of England responsible for the micro-prudential regulation of all banks, building societies and other significant institutions, including insurance companies.**

**This will be operated by a new Financial Regulation Division within the Bank, which will be headed by a new Deputy Governor for Financial Regulation. The FSA will cease to exist and a new**

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**Consumer Protection Agency will take responsibility for consumer protection. Responsibility for micro-prudential regulation will be overseen by the Financial Policy Committee, which will include the new Deputy Governor for Financial Regulation.**

Any institution whose regulation requires prudential judgement will be regulated by the Bank of England. Although Independent Financial Advisers and other small firms such as insurance and mortgage brokers are an important part of our financial services market their regulation is not mainly concerned with prudential judgement. These firms must be regulated but their supervision is primarily concerned with protecting consumers. Therefore they will be overseen by the Consumer Protection Agency (this is discussed in more detail in Part 4).

What is needed is a root and branch change in financial regulation in the UK in comparison to the way it was conducted prior to 2007. This is not merely a matter of transferring one group of people from the FSA to the Bank of England; what we are describing is the step change in financial regulation that is required to protect the stability of the UK financial system in the future. The creation of this new structure will have to be managed carefully. We would seek to ensure those aspects of the operating model that the FSA has recently developed are incorporated into the Bank's new micro-prudential approach. We are consulting widely on the right process for handling the transition.

The establishment of a strong micro-prudential division in the Bank will require a substantial increase in the Bank's resources and expertise. Since the quality of the regulators has a critical impact on the quality of regulation the Bank should seek to capitalise on the FSA's existing expertise and develop it further. This new division will benefit from the Bank of England's status and prestige, which will improve its ability to recruit and retain the best people.

**However, experienced regulators are highly sought after in the private sector, therefore we will also ensure that the Bank has sufficient resources to offer salaries that are sufficient to recruit and retain high-quality regulators. This will mean increasing the industry levy, which will continue to cover the cost of financial regulation under the new arrangements. Clearly it is unrealistic to imagine that regulatory salaries can ever match the highest salaries in the private sector, but we need to narrow the gap.**

**We will also increase the expertise at the Bank by requiring regulated firms to participate in a secondment programme. This type of secondment scheme has been extremely successful at the Takeover Panel, and will help to bring more market experience to bear on the task of regulation.**

We believe that the new division for financial regulation should take a truly risk-focused approach to regulation. This is a significant departure from the FSA's historical approach. By risk-focused regulation we mean that the Bank should have a clear view of the areas and activities that create the greatest risk in individual financial institutions. For our largest and systemically important institutions this means the Bank should have an awareness of the risk exposures by type. The Bank will also need to monitor conduct of business issues in so far as they have implications for an institution's risk profile.

It has been argued that this approach risks creating an additional burden for regulated firms, who will be regulated by two bodies – the Bank of England and the CPA. However by moving responsibility for consumer credit regulation from the Office of Fair Trading to the CPA we are also removing a regulatory body from the financial services industry. Currently more than 75 per cent of FSA regulated firms also have to seek a consumer credit license from the OFT, so integrating the two will remove a significant burden for firms.

Despite the damage done by an absence of appropriate regulation in the last decade, the Government still appear to be preoccupied with the danger of overlap, arguing that “*while it is important to define clearly where responsibility and accountability lies to avoid gaps in regulation, it is equally important to avoid unnecessary overlaps and duplication.*”<sup>21</sup>

This directly contradicts Paul Tucker, Deputy Governor for Financial Stability, who rightly argues that “*handling overlap in a grown-up way is far better than living with underlap, ie gaps, which is much worse for society.*”<sup>22</sup>

## Box 5: The Dutch system of financial regulation

One example of where overlap has been successfully handled is the Dutch system. The central bank (DNB) is responsible for systemic stability and micro-prudential regulation. Conduct of business regulation is conducted separately by the Authority for the Financial Markets (AFM).

There are some areas of overlap between the DNB and the AFM. Both supervisors have duties to supervise the integrity of financial institutions, for example ensuring that they cannot be used for criminal purposes, such as money laundering. There is also an overlap on the payment infrastructure, with the DNB responsible for order operation from a financial stability perspective, and the AFM responsible for promoting open and fair access for different market participants.

In their respective roles of micro-prudential and conduct of business regulators the DNB and AFM also have overlapping information requirements. The Dutch have developed a number of legal, contractual and operational mechanisms in order to minimise any burden for firms, and to increase co-operation between the two regulators.

The Covenant between the DNB and AFM is intended to provide the framework for this cooperation. It includes agreements on:

- The powers and responsibilities of each supervisor in the various sectors of the financial system
- Which elements of financial institutions’ management come under prudential versus conduct of business supervision
- The rules for consultation and information sharing
- A provision for annual reviews of the Covenant

The DNB and AFM have also developed operational tools including:

- Joint supervisory teams for large institutions
- Procedures for notification and consultation of the other supervisory body prior to conducting investigations
- Quarterly board-level meetings with additional standing committees and working groups set up to address specific areas of shared interest

In 2007 the Act on Financial Supervision formalised the duty of the DNB and AFM to minimise unnecessary supervisory costs by creating a legal requirement for the two firms to share data.

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## *The Financial Services Compensation Scheme*

We will look at the case for giving responsibility for the Financial Services Compensation Scheme (FSCS) to the Bank of England. The FSCS is currently an independent statutory body which steps in to compensate consumers in the event that a regulated firm is unable to pay claims against it. The FSCS has played a significant role in the handling of this crisis by facilitating the orderly resolution and customer compensation in the event of significant institutional failures. Under the terms of the 2009 Banking Act the FSCS can also be used for contributing to the costs of an institutional wind-down under the Special Resolution Regime. The Government's White Paper outlines their plans to consult on the exact natures of these powers, and potential changes to the FSCS's governance structure.

**In our framework the Bank will be in charge of triggering and operating the Special Resolution Regime. Therefore there may be a case for also giving the Bank direct control over the FSCS in order to better facilitate future resolutions. We will consult on this proposal.**

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## Part 3: New regulatory tools to ensure financial stability

While changing the regulatory architecture in the UK is crucial, we also need to look at regulatory policy. We need a new “toolkit” of policy instruments that work at both the micro (institutional) and macro (sector) level in order to ensure financial stability.

A Conservative Government will:

- **Empower the Bank of England to ensure that capital and liquidity requirements recognise the additional risk implied by an institution’s size and complexity.**
- **Empower the Bank of England to impose much higher capital requirements on high risk activities such as large scale proprietary trading carried out by banks that also take retail deposits. In practice this could prevent banks that take retail deposits from engaging in many of these high risk activities by making them more expensive. At the same time the Bank will examine the case for a more structural separation of these activities in international policy forums.**
- **Empower the Bank of England to use capital requirements to crack down on risky bonus structures. From the banks’ point of view this will effectively introduce a ‘tax’ on risky bonus structures that encourage employees to put stability at risk for short term profit.**
- **Introduce additional safeguards against the risks created by complex or interconnected institutions through greater central counterparty clearing, a more appropriate balance between exchange-traded and over-the-counter securities, and more financial transparency.**
- **Work at an international level to create a resolution regime for the orderly failure of investment banks, and to design a resolution regime for international banks. We also support the Governor of the Bank of England’s calls for financial institutions to prepare a ‘living will’ to assist with any wind-down.**
- **Introduce a “backstop” leverage ratio limiting how much banks can lend for a given amount of capital. The Basel Committee is currently looking at how such a ratio could be designed. We support this work and believe that a properly designed and internationally agreed leverage limit could provide an additional safeguard for the financial system.**
- **Develop an internationally coordinated macro-prudential toolkit that can be operated by the Financial Policy Committee to control systemic risks at a sector or economy wide level.**
- **Actively shape the intellectual debate on European and global regulation more proactively than is happening at present.**
- **Ensure that there is a single senior Treasury minister with specific responsibility for European financial regulation. That minister will spend as much time as necessary in Brussels to ensure that the Government is fully engaged in the legislative process, build alliances, and defend Britain’s vital interests in an industry crucial for our national prosperity.**

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- **Further strengthen the Treasury’s engagement in Europe by enhancing the team dealing with European issues, and ensure that the Chancellor regularly attends meetings of European finance ministers. We will also begin a new programme to target the positions in the European Commission to which it would be in the UK’s interest to second civil servants.**
  - **Fight any new attempt to create an executive pan-European supervisor.**
  - **Increase European opportunities for UK financial firms by eliminating barriers to entry to European markets for retail financial services, for example by developing proportionate pan-European conduct of business rules in insurance and fund management.**
  - **Continue to support international efforts to reform the financial markets. In particular we believe Britain should seek to play an active role by working with the European and American authorities to find constructive solutions to trans-Atlantic disagreements on areas such as accounting standards, transparency and hedge funds.**

We need to recognise that no system of regulation will ever be perfect. Our institutional reforms will create a strong and powerful Bank of England able to use its authority and judgement to limit institutional and systemic risks. But in any system there will occasionally be firms that fail and there will always be market participants seeking to use financial innovations to escape regulatory constraints. This understanding was sadly lacking over the last decade, but it has important implications. In particular, it means we need a regulatory approach that minimises the costs of regulatory failures if and when they occur.

That means we cannot continue to accept a system where financial institutions have a free option to pursue high-risk strategies with the assurance that the taxpayer will step in to protect them and the rest of the financial system in the event of failure.

Therefore, where the failure of a financial institution would threaten financial stability, the public purse, or consumers, a responsible Government must take steps to protect the taxpayer and the financial system. We need to make sure both that important institutions are less likely to fail and that any failures can be managed without systemic complications.

None of these reforms or protections should be designed to prevent institutions from choosing to pursue high-risk, high-reward activities as long as they do not pose a threat to other parts of the system or impose a cost on the taxpayer. Prudential regulation should be proportional to the risk an institution presents to financial stability, the taxpayer and the consumer. When an institution can realistically be allowed to fail without wider social implications its regulation should reflect this.

The same applies to financial innovation – like any industry the financial sector must be allowed to innovate as long as those innovations do not put financial stability at risk.

## **Micro-prudential regulation**

We need a new philosophy to underpin institutional capital and liquidity management. In the run-up to this crisis capital and liquidity requirements were too lax – the requirements did not adequately reflect the risk faced by specific institutions or the risks posed by specific activities. In the future capital and liquidity requirements must be used as a sophisticated tool to insure against the risks posed by individual institutions and particular activities. These requirements should be discussed at a macro level (discussed in a separate section below) and a micro level.

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At the micro level of individual institutions there are at least five specific considerations that need to be addressed:

- Institutional size
- The inherent riskiness of an institution's business model
- The risks created by short term bonus structures
- Institutional complexity and interconnectedness
- The need to protect retail depositors.

### ***Institutional size***

There has been much discussion about the problems posed by banks which are “too big to fail”. The Governor of the Bank of England has made it clear that in his view institutions which are too big to fail are too big.<sup>23</sup>

Large institutions are likely to do more damage when they get into trouble: the losses have the potential to be much larger, plus they have more counter parties and more consumers so the impact on confidence is likely to be greater. There is a danger that the perception of being too big to be allowed to fail could lead an institution to take risks that smaller institutions dare not take.

For example, as the Bank of England's Executive Director for Markets Andrew Haldane has shown, there is evidence to suggest that even before the crisis there was a positive relationship between a bank's size and its expectation of support from the state.<sup>24</sup> Larger financial institutions have also tended to maintain lower capital buffers than their smaller counterparts.<sup>25</sup>

Moreover as these banks grow there is a risk that they could become too large for the taxpayer to be able to bail out. For example Royal Bank of Scotland has total liabilities of £2.06 trillion, significantly larger than national output at 142% of UK GDP.<sup>26</sup>

### **Box 6: The Swiss Authorities' attitude to large banks**

In December 2008 the Swiss Financial Market Supervisory Authority (FINMA) issued decrees imposing higher capital requirements on its two biggest banks UBS and Credit Suisse.<sup>27</sup> As a result the risk risk-weighted capital requirements for these two banks will double. Liquidity requirements for big banks are still in the process of being revised by FINMA.

However, the Swiss Authorities are considering going further. When the Swiss National Bank unveiled its stability report in June 2009, Philipp Hildebrand, vice-chairman of the SNB raised the prospect of splitting up the country's largest banks, saying: *“There can be no more taboos, given our experiences of the last two years.... There are advantages to size...[but] in the case of the large international banks, the empirical evidence would seem to suggest that these institutions have long exceeded the size needed to make full use of these advantages.”*<sup>28</sup>

Of course the size of an institution is not the only determinant of the risk it poses to financial stability. This is particularly true if there are fears that an institution's failure is indicative of a wider systemic crisis (as was the case with Bradford & Bingley). However size clearly does contribute to an institution's risk profile and to its impact on the wider economy in the event of a failure.

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**The Bank of England should use its powers under Pillar II of Basel (and its successors) to ensure that capital and liquidity requirements recognise the additional risk implied by an institution's size. Making these requirements scale sensitive ensures that institutions whose failure poses a larger danger to the financial system would be required to hold larger buffers against failure. From the banks' point of view this approach amounts to a "tax" on size.**

This approach should also be taken on an international level. Simply encouraging large firms to relocate some of their activities to other jurisdictions has few advantages for financial stability.

We will also address the potentially harmful effects of consolidated 'super-banks' on competition in the banking industry. This issue of competition policy is covered in more detail in Section 4.

### *Risky business models*

**We will also expect the Bank to impose much higher capital requirements on high-risk activities, for example, large-scale proprietary trading carried out by banks that also take retail deposits. In practice this could prevent banks that take retail deposits from engaging in many of these high risk activities by making them more expensive.**

Concerns about retail banks using their capital base to fund this sort of high-risk activity have led some to argue that we need a modern version of the separation between retail banks and investment banks imposed by the Glass-Steagall legislation in the US from the 1930s to the 1990s.

While there are some valid arguments for this approach if implemented at an international level, it would not be feasible or desirable for the UK to impose an absolute separation unilaterally.

**Instead, we will instruct the Bank of England to instead use capital and liquidity requirements to achieve the same objectives, while continuing to examine the case for a more structural approach in international forums.**

Box 7 discusses the case for a more structural approach in more detail.

### **Box 7: Structural solutions to the free option problem**

There has been much debate about whether a modern version of the "Glass Steagall" split would provide taxpayers with greater protection from any future banking losses. The discussion centres on the future of 'universal' banks – institutions which combine retail banking activities (the traditional deposit taking and lending of high street banks) with risky investment banking activities (such as proprietary trading). Many economists and policy makers have expressed concerns that this model allows universal banks to use their capital base – which is implicitly guaranteed by the government – to fund their riskier investment banking activities, thereby exposing depositors and taxpayers to significant risks.<sup>29</sup>

This case should be examined, and has some very well respected proponents. Paul Volcker and Nigel Lawson are among those who have called for a new settlement to separate some of the riskier activities of investment banks from the 'utility' activities of retail banks. In this system the taxpayer would stand behind the deposit taking institutions, but to protect the taxpayer these retail banks would be prevented from undertaking certain high-risk activities. In these heavily regulated banks, failure would be much less likely. Institutions that did not take retail deposits, on the other hand, would have much more freedom to innovate but would be allowed to fail.

Critics of this approach point to the catastrophic consequences of the failure of Lehman Brothers (a pure ‘investment’ bank), though Lehman Brothers had counterparties that were universal banks, and argue that in practice it would rarely be possible to allow investment banks go bust. They cite the ‘synergies’ between different financial services, the claimed benefits for customers and the potential reduction in risk for banks with diversified activities. They also point to the potential difficulties of defining the riskier “investment banking” activities that should be prohibited. After all, many activities carried out by investment banks are low risk, such as corporate finance advisory work. Many ‘plain vanilla’ investment banking activities sit naturally alongside retail banking activities.

Nevertheless there remain some valid arguments in favour of some degree of structural separation between the riskiest banking activities and deposit taking institutions.<sup>30</sup> These activities might include:

- Large-scale proprietary trading
- Internal hedge funds or private equity funds
- Significant equity stakes in companies with lending relationships

It is undoubtedly the case that this would at the very least reduce the scale of the free option problem and would go some way towards protecting the broader economy in the event of a crisis. However, unilateral action in this area would be neither feasible nor in the broader interests of British taxpayers. Not only would it be likely to do significant damage to the UK’s competitiveness as a global financial centre and drive some of our most successful banks offshore, but without similar action in other major jurisdictions the benefits in terms of financial stability would be questionable.

For this reason, while the Bank of England should continue to pursue international discussions on the feasibility and desirability of prohibiting deposit-taking banks from engaging in certain high risk activities, it is not a course of action we should consider implementing unilaterally.

We do, though, need to address the problem that universal banks may expose the taxpayer to greater risks than narrow retail or commercial banks.

We believe that the Bank of England should address this risk by requiring retail banks that engage in riskier investment activities to hold more capital and liquidity against those activities. At the very least this would create a buffer against possible losses. Ultimately this approach would result in the separation of the riskiest activities if retail banks find the additional costs of engaging in them are too great.

This approach is similar to the approach taken by Spanish regulators to off-balance sheet vehicles over the last few years. Because they attracted strict capital requirements, these structures were effectively priced out of the market. This went some way to limiting the effects of the crisis on the Spanish banking system.

This approach should be combined with better resolution procedures for failing banks, more central clearing to reduce counterparty risk, and an important new requirement that all large institutions should have to prepare a ‘living will’ to assist in any resolution.

## ***Risky bonus structures***

In addition to looking at specific high-risk activities the Bank should consider the risk culture encouraged by an institution's pay structure. It has been clear for some time that irresponsible remuneration practices contributed to the financial crisis by encouraging individuals to pursue high risk, short-term profits.

As Nobel Prize winner Joseph Stiglitz explains, the bonus culture in the City *“was designed to encourage risk-taking – but it encouraged excessive risk-taking. In effect, it paid them to gamble. When things turned out well, they walked away with huge bonuses. When things turned out badly – as now – they do not share in the losses”*.<sup>31</sup>

The Conservative Party has argued that where an institution's bonus culture promotes short-term profits at the expense of long-term sustainability it should be required to hold capital to reflect its additional risk. Although the FSA has endorsed this approach, the Treasury Select Committee has expressed concern that the FSA does not appreciate the importance of remuneration structures in contributing to institutional risk.<sup>32</sup>

**It is imperative that the misalignment between individuals' incentives and the long-term interests of shareholders and financial stability be corrected. We will expect the Bank of England to make addressing this misalignment a priority, and to do so through its powers to set capital requirements. From the banks' point of view this will effectively introduce a 'tax' on risky bonus structures that incentivise employees to seek short term profits at the expense of longer term stability.**

**These rules would be designed so that banks introduce new structures such as claw-back options, under which past bonuses would be withdrawn if the bank gets into difficulty. We must be clear that the price of implicit taxpayer backing is more responsibility by the bankers themselves, and we will penalise those who fail to act responsibly.**

### **Box 8: Reforming Corporate Governance**

The failures in the banking system exposed numerous failures in corporate governance: remuneration that encouraged reckless risk-taking, boards that did not understand their companies' activities and shareholders who were disengaged from their investments. We need sweeping reforms to improve corporate governance in the financial sector.

It is beyond the remit of this paper to tackle corporate governance questions and the Walker Review is addressing a number of these concerns. However, it is clear that another committee and another voluntary code of conduct will not be sufficient.

We need more transparency on pay structures, and regulators must also ensure capital requirements take into account the risks encouraged by bonus structures. We need to improve the internal risk management structures in banks – for example it may be appropriate for the risk director to be appointed by the Board, not the CEO, to safeguard their independence.

We also need to encourage a new shareholder activism. Investors must have the ability to hold management to account. This may mean greater financial disclosure, requirements that institutional shareholders vote, or annual re-election of directors. Boards also need to be strengthened, with measures to safeguard against 'group think' and ensure proper NED engagement. If the current Government fails to address these issues then a Conservative Government will put in place reforms to do so.

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## *Complexity and interconnectedness*

**Where an institution's complexity or interconnectedness is the underlying reason for its systemic importance, increased capital and liquidity requirements also provide part of the solution. By discouraging expansion into certain activities, capital requirements on specific activities could help to discourage an institution from becoming overly complex.**

A more sophisticated and dynamic use of capital and liquidity requirements is not the only step the Bank of England should take to tackle institutional risk.

**We will introduce additional safeguards against the risks created by complex or interconnected institutions through greater central counterparty clearing, a more appropriate balance between exchange traded and over the counter securities, and more financial transparency. These measures will help to give regulators the confidence that an orderly wind-down is possible.**

**Though we do now have a system for resolving the failure of retail banks, we still need an equivalent system for investment banks. Creating such a resolution regime should be a matter of urgency for the authorities and will be a priority for an incoming Conservative Government should the issue still be outstanding. The challenge of designing resolution regimes for international banks should also be addressed urgently at an international level.**

**We also support the Governor of the Bank of England's calls for financial institutions to prepare a 'living will' to assist with any wind-down.**

**In addition to all of these measures we will also introduce a "backstop" leverage ratio limiting how much banks can lend for a given amount of capital. The Basel Committee is currently looking at how such a ratio could be designed. We support this work and believe that a properly designed and internationally agreed leverage limit could provide an additional safeguard for the financial system.**

## *Protecting retail depositors*

Finally we also need to address the way in which consumers are protected against bank failure. The Conservative Party helped to lead the campaign to increase the level of deposit insurance to £50,000 and to speed up the process of paying out.

Currently this insurance is administered by the Financial Services Compensation Scheme (FSCS) which is post-funded. Whilst there are strong arguments for a pre-funded scheme, there must be a rigorous cost benefit analysis of a move towards this approach. In a future upswing, requiring banks to set aside capital for the FSCS could act as a further counter-cyclical measure, but doing so during a downturn risks damaging the economy further by reducing lending capacity.

Any pre-funded scheme would also need to take into account measures that are taken to prevent bank failures through higher capital levels. We also recognise that the cost of pre-funding could have a significant impact upon building societies and credit unions.

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## Macro-prudential regulation

In addition to regulatory tools designed to work at an institutional level we need an internationally coordinated approach to macro-prudential regulation.

**We will develop a “macro-prudential” toolkit that can be operated by the Financial Policy Committee to control systemic risks at a sector or economy wide level.**

Counter-cyclical capital requirements will play an important role here. As George Osborne said in a speech to Harvard Business School last April, “*counter-cyclical capital requirements could also help to dampen the unhelpful pro-cyclical tendencies built into the Basel accords – which tend to encourage risky lending during a boom and to discourage lending when times are difficult.*”<sup>33</sup>

Many of these macro-prudential tools must be developed, negotiated and operated through international coordination because systemic risks do not respect national borders. They are likely to include powers to change capital requirements and liquidity thresholds and to place caps on inter-bank lending for individual systemically-important institutions and clusters of institutions when facing greater risk.

The BIS Committee on Banking Supervision, for example, has been considering proposed changes to the capital standard requirements under Basel II for several years. The Committee is now considering proposals for a counter-cyclical capital regime and is looking at definitions of capital.

Part of this global debate must include an analysis of the impact of tighter capital and liquidity regimes on the potential growth rate of economies. Indeed we should recognise that in the current downturn, for all the talk of counter-cyclical regimes, regulators are currently tightening liquidity requirements and raising capital requirements. The failure to rein-in irrational exuberance during the good years followed by the current raising of standards mean that the economic cycle has become exaggerated. It is in everyone’s interests to prevent this exaggeration in the future. Therefore we need to understand how the operation of any new regime will affect the availability of credit and therefore the impact on the short and medium term development of national and global economies. This analysis should inform the timing of introducing new standards and the process of doing so.

**Given the position of London as a global financial centre, the Bank of England, and the Financial Policy Committee in particular, will actively shape the intellectual debate on European and global regulation more proactively than is happening at present.**

Box 9 discusses a range of other approaches to reducing systemic risk.

### Box 9: Further reforms to reduce systemic risk

This crisis revealed weaknesses across all dimensions of the financial system, all of which will need to be addressed. The international authorities are currently working on solutions to a number of these vulnerabilities and a Conservative Government will expect the Treasury and the Bank of England to take an active role in shaping these discussions.

#### *Credit rating agencies*

The credit rating agencies played an important role in creating the credit bubble at the heart of the financial crisis. Regulators and banks alike became overly dependent on agencies’ ratings.

Moreover it is now apparent that many of the ratings awarded were clearly misleading as a true indicator of risk. Ultimately the false confidence provided by “optimistic” ratings encouraged banks to reach dangerous levels of risk exposure and to manufacture and sell on dangerously risky instruments.

Therefore we need reform to both the operation of the agencies and the use of ratings. Greater transparency and disclosure should be at the heart of these reforms. Agencies need to be more upfront about their rating methods and their internal safeguards against the potential conflicts of interest that arise from their “issuer pays” business. National regulators also need to re-examine their use of ratings in their regulatory assessments. The European Commission is already working on regulation that will address these issues. However as most of the major rating agencies are based in the United States, it is important that the UK continues to work towards global reforms. We welcome the Security and Exchange Commission’s proposals in this area, and the US Administration’s commitment to strengthening the integrity of the ratings process.

### ***Securitisation***

The ‘originate and distribute’ model facilitated by securitisation was meant to disperse risk and thereby promote financial stability. However, in reality, the practice dramatically increased the risk in the system by eroding normal market disciplines. Allowing lenders to pass on all of the risks associated with the loans they made led to riskier lending. Packaging individual loans into large tranches of debt for resale obscured the value of the underlying assets, which meant investors had very little direct understanding of the risks they were taking on and became dependent on rating agencies. The use of off-balance sheet special purpose vehicles to hold securitised assets also let institutions disguise the risks they had taken on.

Securitisation is likely to continue to play an important function in global financial markets. As a mechanism for intermediation and risk sharing it has the potential to increase market-wide efficiency. However, globally coordinated reform is needed to prevent securitisation leading to irresponsible lending, ill-informed investment or a reduction in transparency. We support proposals to require originators to retain a material economic interest in securitised products. The Basel committee on Banking Supervision is also right to look at increased capital charges for some products, including re-securitisations. We will expect the Bank of England to continue its work with the international authorities to shape these reforms.

### ***OTC derivatives***

In the decade preceding the financial crisis trading in over-the-counter derivative contracts, particularly credit default swaps (CDS), expanded dramatically. By the end of 2007 institutions and investors had a gross nominal exposure to CDS positions of \$60 trillion.<sup>34</sup> The size, interconnectedness and complexity of this market, and the fact that trades take place almost entirely over-the-counter, creates a danger that the failure of any significant counter-party could cause systemic disruption. To mitigate this risk we need more use of centralised counter-party clearing houses.

The European authorities plan to shift a significant proportion of CDS trading to central counterparty clearing in the coming months. We will continue to monitor progress towards this goal

and will make it clear that it is unacceptable for the European authorities to use this goal as a pretext for requiring business to be transferred from outside to within the eurozone. As the global centre of much of this activity, London must be the home of any European clearing house for derivatives , and a Conservative Government will fight to make sure that it is.

### *Alternative Investment Fund Managers*

The activities of hedge funds and private equity firms were not at the heart of this crisis. Therefore it would be wrong to assume that dramatically curtailing activities in these industries will necessarily increase financial stability. The Conservative Party does not support the poorly drafted and protectionist Alternative Investment Fund Managers Directive. However, it is right to look at the sector and consider whether reform would benefit financial stability now and in the future.

For example, there may be a case for improving the Bank of England's power to access information from 'shadow' institutions. The regulator must be able to monitor appropriately institutions which it believes may have systemic importance. Other international authorities have suggested greater disclosure in reporting. The Bank of England should continue to look at these issues and satisfy itself that there is sufficient understanding and oversight of institutions which may at some stage in the future pose a threat to the economy's financial stability based on either their size, leverage or interconnectedness to the financial system.

### *Accounting*

The pro-cyclical effect of fair-value (mark-to-market) accounting is well established, and the Conservative Party raised concerns about its effects early on in the crisis last autumn. In an asset bubble mark-to-market accounting inflates declared profits. In the run up to the current crisis these inflated profits resulted in larger bonuses and an incentive for management to take on even more risks - pumping up the bubble further. In a falling market institutions are required to mark their assets down to the market, putting pressure on their capital which may then drive further asset sales and put further downward pressure on the market.

We support the ongoing work of the international authorities on how to address the pro-cyclical aspects of mark-to-market. Changes to accounting standards must be global; therefore it is right for the International Accounting Standards Board to continue to lead in this area, although the Bank of England must continue to remain engaged in this process.

## **Engaging in the European and International debates**

### *European Reform*

The European authorities play a significant role in shaping the future of the UK's financial services sector. For example, the rules on bank passporting mean that the prudential supervision of some of the largest businesses in London rests with their home regulator and not with the UK authorities, whilst also allowing UK businesses to trade in mainland Europe without being subject to the capital requirements of the host markets.

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If well designed, European legislation could improve European regulation, help prevent another crisis and further open up competition amongst financial services firms across the single market. However, ill-considered regulation threatens to move significant parts of the financial services industry out of the EU to the detriment of EU users of financial services and to employment in the EU.

Yet despite the growing importance of Europe, evidence suggests that Treasury ministers are currently ineffective at influencing the European agenda. The Sassoon Review highlighted the problem, saying that in the past year *“the UK authorities’ voice has been publicly silent on the European dimension - and that the authorities have done little to co-ordinate a clear UK public-private sector view on how the interests of the UK in terms of financial stability and competitiveness would be best served.”*<sup>35</sup>

As the proposed Alternative Investment Fund Managers Directive has shown, this lack of engagement is likely to lead to significant damage to the UK’s national interest. Clearly, Europe has an important role to play in creating a framework to protect financial stability, and regulation that continues to open up the European markets could provide opportunities for future growth. However, Europe has the power to impose significant regulatory burdens on our financial services industry – whether the Government approves of the changes or not. To both protect our interests and capitalise on opportunities a Conservative Treasury, working with our own large group of MEPs and with UK MEPs from all parties, will actively engage with Europe to make sure that any new regulations are appropriate for London and for the wider British and EU economies.

We will work to build coalitions with member states to ensure that European financial services develop to the benefit of the UK and Europe as a whole. The Government must win the argument in Europe that diminishing London’s ability to compete will not lead to a stronger Paris or Frankfurt, but to the relocation of business outside Europe. This would be to the detriment of European firms with significant activities in London such as Deutsche Bank and Societe Generale, to the detriment of all the European companies that are financed through the London markets and to the detriment of European households whose savings are channelled through the UK market.

Active engagement with Europe is the best means by which the UK can protect its interests – it will always be more effective to prevent damaging legislation reaching the drafting stage than to try to contest proposals as they go through the Council and the European Parliament. For example, the Government should now be seeking to lead the debate on new capital and liquidity requirements rather than having to react to unsatisfactory proposals in the future.

**For as long as the EU is dealing with the proposed package of legislation on financial services, there will be a single senior Treasury minister with specific responsibility for the whole package, directly responsible in turn to the Chancellor. That minister will spend as much time as necessary in Brussels to ensure that the Government is fully engaged in the legislative process, fully on top of all developments in every EU institution and able to defend Britain’s vital interests in an industry crucial for our national prosperity**

**We will further strengthen the Treasury’s engagement in Europe by enhancing the team dealing with European issues, and the Chancellor will regularly attend meetings of European finance ministers. We will also begin a new programme to target the positions in the European Commission to which it would be in the UK’s interest to second civil servants.**

**A Conservative Government will also be committed to fighting any new attempt to create an executive pan-European supervisor. There are good arguments for national regulators to work together to strengthen the single market and coordinate responses to macro-prudential risks. We**

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**also want to increase European opportunities for UK financial firms by eliminating barriers to entry to European markets for retail financial services, for example by developing proportionate pan-European conduct of business rules in insurance and fund management. We will work with the three new authorities responsible for banking, insurance and securities regulation in order to achieve this.**

However, while there is a role for European authorities to coordinate arbitration in disputes between national regulators, they should not have any executive powers which could conceivably have fiscal consequences for national governments, for example in the case of a bank failure. British taxpayers are ultimately liable for failures of financial services regulation and therefore the British authorities must retain regulatory sovereignty when taxpayers' money is at risk.

### ***Global reform***

In the last few decades financial markets across the globe have become increasingly integrated. Protecting the UK's economy, while opening up opportunities for UK financial services firms across the world, will therefore require global, and not just European, reforms. We agree with the Managing Director of the IMF's view that *"Open financial systems provide tremendous economic benefits...But all of this only works if there is good oversight. Much of this oversight and regulation will continue to be done at the national level. But given the globalization of financial markets, there also needs to greater international coordination."*<sup>36</sup>

There is already significant post-crisis activity and proposals are coming forward from a number of different bodies.

The Basel Committee is reviewing capital requirements with a view to better reflecting the risks of banks' activities and off-balance sheet vehicles as well as tackling the pro-cyclicality of the existing requirements.

*In April 2009 the Financial Stability Board (FSB) was set up to replace the Financial Stability Forum (FSF). The FSB includes all members of the G20 (among others) and its mandate is "to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability"*<sup>37</sup>. In its previous incarnation the FSF put forward a number of proposals on topics on a variety of policy areas including – capital requirements, corporate governance and the role of credit rating agencies.

The IMF are looking at how to improve the global system of early warnings and their own crisis management.

The International Accounting Standards Board is also currently undertaking round table discussions, consultations and internal research with a view to addressing criticisms of their accounting standards. Particular focus is being given to off-balance sheet vehicles and fair value accounting.

**We will continue to support international efforts to reform the financial markets. In particular we believe Britain should seek to play an active role by working with the European and American authorities to find constructive solutions to trans-Atlantic disagreements on areas such as accounting standards, transparency and hedge funds.**

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## Part 4: Better consumer protection

The Conservative Party has had long-standing concerns about poor consumer protection in the financial services sector. Consumers have suffered as a result of bad advice and mis-selling, and from a lack of competition in some markets. We believe that the regulatory architecture and culture needs substantial reform in order to provide proper protection for consumers.

A Conservative Government will:

- **Create a new Consumer Protection Agency (CPA). The CPA will take a much tougher approach to consumer protection and will be given a mandate to act as a consumer champion. It will be a far more consumer-orientated, transparent and focused body than the FSA.**
- **Transfer regulation of consumer credit from the Office of Fair Trading to the CPA. This will create a unified regulatory regime for financial services firms and consumers.**
- **Ensure that the CPA names and shames firms which break the rules. This will act as an incentive for firms to improve their behaviour.**
- **Force banks to be more transparent about their retail consumer charges. Effective competition relies on consumers being able to make informed choices. Increasing transparency on charges will help consumers compare products. This approach is also being pursued by the Obama administration in the US.**
- **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. The findings of the OFT and the Competition Commission will help to inform a Conservative Government's ongoing strategy for disposing of its banking shares.**
- **Look to reduce barriers to entry for new banks and building societies in order to increase competition and diversity in the UK banking market.**

Much of the analysis of the financial crisis has focused on the FSA's inadequate micro-prudential regulation, but in the past few years there have been numerous examples of unfair treatment of consumers – the mis-selling of payment protection insurance and unfair bank charges are just two of the largest currently unresolved examples.

Moreover, we should not lose sight of the fact that this crisis was fuelled in part by poor lending practices. The rise of 'sub-prime' lending in the UK allowed individuals to take on far more debt than they could afford. Practices such as 125 per cent mortgages and inappropriate self-certification have had consumer as well as prudential implications. Sub-prime lending contributed to the failure of banks like Northern Rock and Bradford & Bingley, but it has also left many households struggling to manage problem debt.

The failures on consumer protection have stemmed in part from a dysfunctional regulatory framework and in part from the FSA's emphasis on compliance rather than acting as a genuine guardian of the consumer's interest.

Currently the architecture for consumer protection is divided and confused. Responsibility for protecting financial services consumers is primarily split between the FSA and the Office of Fair Trading (OFT).

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The Financial Services and Markets Act 2000 gives the FSA a statutory objective for “*securing the appropriate degree of protection for consumers*”<sup>38</sup> of financial services. In practice this means the FSA is responsible for regulating most financial services and products<sup>39</sup>. However, under the Consumer Credit Act 1974 the OFT is responsible for regulating all consumer credit (other than first charge mortgages)<sup>40</sup>. This is an illogical division, which weakens consumer protection and increases the regulatory burden on firms.

From a consumer perspective it means, for example, that their first charge mortgage lender is held to a different standard of behaviour from their second charge lender. From an industry perspective it means firms have to seek authorisation from two bodies and meet two separate set of rules. Currently around 75 per cent of the firms regulated by the FSA are also licensed by the OFT.<sup>41</sup>

The culture of consumer protection also needs reform. The Chief Executive of Which? is right to argue that “*we need more direct and proactive intervention from the regulator. Firms have been allowed to run their products, and their lending criteria too freely, and get away with offering poor quality advice with little intervention from the FSA, and that has contributed to the problems we see today.*”<sup>42</sup>

Alongside better regulation we also need ensure effective competition in financial services. This means examining the structure of the banking market and looking at ways to encourage new entrants.

## A strong new Consumer Protection Agency

**Alongside a strengthened Bank of England with responsibility for protecting the financial system from risk, we will create a strong new Consumer Protection Agency (the CPA) with responsibility for protecting consumers. This will create a new framework and culture for consumer protection regulation.**

**The CPA will inherit the FSA’s responsibilities for consumer protection but it will also take on the responsibility for consumer credit regulation that currently lies with the Office of Fair Trading.**

This merger will create a single authority with responsibility for consumer protection across the financial services industry. It will provide one point of accountability and greater regulatory consistency for consumers. By consolidating licensing requirements into one body it will also reduce the burden on firms. Moreover, by creating an integrated agency with enhanced powers and responsibilities we will increase the prestige and profile of consumer protection regulation in the UK.

### Box 10: Overlap between the OFT and the FSA

The OFT’s responsibility for consumer credit means that responsibility for protecting financial services consumers is fundamentally divided. Under the Consumer Credit Act 1974, amended in 2006, most businesses that offer goods or services on credit or lend money to consumers require a licence from the OFT. Separately, firms whose activities fall under the Financial Services and Markets Act 2000 (FSMA) also have to be authorised by the FSA.

This means that there are significant overlaps in authorisation - currently around 21,000 of the firms regulated by the FSA also hold an OFT consumer credit licence<sup>43</sup>. For example a firm may be authorised and regulated by the Financial Services Authority for the provision of mortgage advice and arranging insurance but licensed by the OFT to carry on the business of consumer credit, debt adjusting and debt counselling.

The current framework for consumer regulation means that protecting a customer who wants a personal current account with an overdraft involves a complicated division of responsibilities. The deposit taking activities are technically regulated by the FSA<sup>44</sup>. However the transparency requirements on credit are determined by the OFT, with responsible lending and credit assessment by the Banking Code Standards Board (BCSB to be replaced by a Lending Standards Board later this year), meanwhile the data used to assess a lending proposition is the responsibility of the Information Commissioner's Office.

So while the setting of an overdraft is overseen by the BCSB, as soon as it is used the standards required are enforced by the OFT, having been developed by the Department for Business Innovation and Skills and prescribed in law. The OFT and FSA share responsibility for ensuring contract terms are fair.

If the consumer gets into financial difficulties the solution agreed or proposed can be regulated by the OFT, the courts or the insolvency service; unless the overdraft is covered by a protection insurance, which is the responsibility of the FSA.

### *A strong consumer focus*

However, a new regulatory architecture is not enough. We also need a new culture of consumer protection. We will ensure that the CPA takes a far tougher approach to consumer protection than the FSA has historically demonstrated.

**We will give the CPA a mandate to act as a genuine consumer champion – looking at pricing and product suitability as well as competition in financial services and products. Under the CPA consumer protection will not simply mean following rules. Consumer regulation, like prudential regulation, requires regulatory judgements.**

While taking a tougher approach to enforcement and, where appropriate, product regulation, the CPA will also consider the consumer benefits of competition and low-priced products. For example an expensive sales process which makes some products unaffordable may not ultimately be in the interest of consumers. Equally the proliferation of choice in some instances has limited consumers' abilities to make effective comparisons. These are complicated issues and in order to properly protect consumer interests the CPA will be a far more consumer-orientated, transparent and focused body than the FSA.

There is no consumer representation on the existing FSA Board. Ten of the twelve members are currently, or have previously been employed in the financial services industries. This may have diminished the regulator's understanding of consumers and willingness to challenge the industry.

**We will require that the CPA's Board always contains at least two members who are specifically appointed to ensure that the consumer perspective is fed into the whole of the Board's policies.**

**We believe that the CPA must be open to greater scrutiny and subject to greater public accountability. In addition to regular examination by the Treasury Select Committee we will ask the National Audit Office to assess the CPA's performance and value for money. This will provide an additional means of holding the regulator to account.**

The CPA must also be tougher than the FSA at holding the industry to account for its actions. For example, in its thematic market reviews the FSA does not 'name and shame' firms in breach of their

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regulatory obligations. And whereas the Advertising Standards Authority publishes information about which firms have been forced to withdraw or amend misleading promotions, the FSA does not.

This policy of secrecy provides firms with protection against public embarrassment and means consumers are denied information that could help inform their decisions. We believe that greater disclosure could provide a powerful incentive for firms to meet their responsibilities towards consumers. As the Financial Services Consumer Panel has argued *“The FSA should be a more transparent regulator. FSA should name and shame firms who are in breach of regulatory obligations. Consumers have a right to know more about the shortcomings of the firms with whom they deal well before the ultimate sanction of enforcement action by the FSA. Enforcement is not the only regulatory tool used by the FSA to change firms’ behaviour and we would like to see the full suite of tools deployed more transparently.”*<sup>45</sup>

**Therefore we will expect the CPA to name firms in breach of consumer protection regulations. We will also require the CPA to disclose any action it takes against misleading financial promotions.**

The FSA also requires firms to submit details of the numbers of complaints they receive and how these complaints are handled.

**We believe that requiring firms to publish more information about the complaints they receive, and how they are dealt with, would provide an incentive for firms to improve their customer complaints handling. It could also help inform consumers. Therefore the CPA will ensure that this material is made public.**

### ***More transparency on bank charges***

We will require banks to be more upfront with consumers about their charges. In order to create effective competition in financial services consumers must be in a position to exercise choice based on a comparison of competing products. Currently a lack of transparency in financial services products, combined with limited consumer financial capability, often makes this impossible.

Regulators need to address this market failure. We have already put forward a number of proposals that recognize the need to provide greater consumer protection – for example, banning excessive interest rates on store cards. We are also committed to introducing reforms which will increase the competitive pressures within the industry. For example we will increase transparency on credit card charges to help consumers make responsible borrowing decisions and assess rival offers.

This is in addition to our requirement that credit card bills should include prominent “illustrative scenarios” that explain exactly *how much* credit will cost if only minimum repayments are made every month. This information will also include details of *how long* it will take to repay credit if only minimum amounts are repaid, as well as information about how much money could be saved if larger amounts are repaid each month.

**A Conservative Government will require all credit card statements and advertisements to contain standardised information about borrowing costs. This will include much greater disclosure in a new, clearer “summary box” information. This will be put on a statutory basis for the first time.**

This “summary box” will enable customers to make a genuine comparison of different credit card offers, by ensuring that lending organisations provide standardised information about interest rates, penalty charges and other important features of the credit instrument. This will help consumers choose between competing offers.

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**A Conservative Government will also require all credit card providers to send their customers a data file containing two important categories of information: pricing and usage.**

The pricing information would include all the ways that a consumer can be charged. For example, a credit card provider would list its charges for late payments, foreign currency transactions, cash advances and so on. The usage information would consist of the information on this customer's activity with the card for the past year. This would include the number of late payments, the number of foreign transactions and other usage data.

Consumers will be able to upload this machine readable raw data onto third party price comparison websites, which can then use this information to provide detailed advice on whether other credit card providers could deliver better value for money, given that consumer's precise usage behaviour.

These third party web sites would have their own disclosure requirements, meaning that they would have to reveal any compensation they receive from providers or any other potential conflict of interest.

We believe that a similar approach should be adopted across a range of products in order to help consumers differentiate between competing offers. In addition to credit cards, we believe this approach could be applied to current and savings accounts, as well as mortgages.

This innovative post-bureaucratic policy will make markets more competitive and help consumers get a better deal by increasing transparency, enabling switching and promoting better informed choice.

It was developed by Professor Richard Thaler of Chicago University, who is advising us on the technical implementation of the scheme. The Obama administration in the United States is also planning to adopt this policy.<sup>46</sup>

Another important aspect of the CPA's remit will be promoting public understanding of the financial system (currently one of the FSA's statutory objectives). Personal debt has become a serious problem in the UK, and the CPA will have a significant role to play in helping individuals make more responsible financial choices. The Conservative Party is committed to improving consumers' financial awareness and capability. We have been committed to rolling out a free national financial advice service since April 2008 – we are pleased that the Government has heeded these calls and finally announced similar plans for a national helpline in their July 2009 White Paper.<sup>47</sup>

### ***Financial Crime***

The FSA has historically taken a weak stance on enforcement – infrequently pursuing criminal prosecutions and levying fines that are much lower than those imposed in other industries<sup>48,49</sup>. The Conservative Party has long called for a much tougher approach to financial crime. Where the regulator suspects criminal activity this should result in a criminal investigation, prosecutions and, where appropriate, prison sentences. Fraud and financial crime cannot be allowed to go unpunished.

As David Cameron argued in December 2008 *“FSA and the SFO should be following up every lead, investigating every suspect transaction. And the government should be urging them on, because we need to make it one hundred percent clear: those who break the law should face prosecution...If we're going to build a strong and fair society, individuals must carry the consequences of their own actions - regardless of who they are, where they come from, and what their background is. There cannot be one law for the rich and another for everyone else.”*<sup>50</sup>

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The Sassoon Review questioned whether financial crime policy should remain one of the FSA's responsibilities. Others, such as Sir Ken McDonald, have suggested that the UK needs a new regulatory and enforcement authority to replace the FSA and Serious Fraud Office.<sup>251</sup>

**Those who commit financial crimes should face criminal prosecution and the prospect of a custodial sentence. We will ask the CPA to review its capacity to bring prosecutions and will ensure that the regulator has all the powers it needs to pursue criminal cases. We will also look at the case for a single regulator to tackle financial crime.**

In the last few weeks the FSA has opened a consultation on increasing the fines it levies. We will assess the outcome of that consultation and any subsequent action.

**We believe that in order to provide a credible deterrence to firms the CPA should impose fines that are significantly larger than those that have historically been levied by the FSA.**

### *Additional responsibilities*

The FSA has a number of responsibilities beyond consumer regulation and the CPA will inherit some of these duties.<sup>52</sup>

Most significantly it will retain responsibility for complete regulation of the majority of the 17,000 small firms currently regulated by the Small Firms and Contacts Division (only credit unions, as deposit takers, would be moved under the Bank's remit). These firms include mortgage and insurance intermediaries, stockbrokers and small asset managers. Currently they are not "relationship" managed, but instead deal with the customer Contact Centre. Their regulation does not require prudential judgement, but rather conformity with set requirements. Therefore there is no need to this work to be taken over by the Bank of England.<sup>53</sup>

We will consult on which regulatory authority should take on the FSA's various other responsibilities including markets and securities regulation, 'approved persons' licensing and listing authority responsibilities. For example, markets regulation could be combined with the Takeover Panel and Financial Reporting Council to streamline the number of regulators and create a powerful markets authority akin to that in France, Italy, Spain, Portugal and most of Eastern Europe. We will consult on this idea.

### *Working with the Bank of England and the Financial Ombudsman's Service*

With the Bank in charge of prudential regulation and the CPA in charge of consumer focused issues clearly there will need to be processes to minimise unnecessary duplication for firms and ensure that prudential regulation is informed by relevant consumer concerns (and vice versa).

We are committed to handling the inevitable and necessary degree of overlap in a way that maximises protection for consumers and minimises the burden on firms consistent with good regulation.

**We will ensure that co-operation and the exchange of information underpin a very close working relationship between the Bank and the CPA. At a senior level this will be facilitated by the Chief Executive of the CPA sitting on the Financial Policy Committee, and at a junior level it will be cemented by secondments between the two organisations.**

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As discussed in Box 5, in the Netherlands a series of additional measures have been implemented to minimise the burden of firms and maximise the efficacy of regulation by proper management of the relationship between the country's two regulators. We propose that similar measures be put in place in the UK, including a statutory duty to cooperate.

The CPA will also have to work closely with the Financial Ombudsman's Service (FOS). The FOS plays an important role in consumer protection as it provides a further means of resolution where a consumer has exhausted a firm's complaints' procedure.

**We will ensure that the work of the CPA and the FOS is closely coordinated to support consumers and to create greater clarity on the application of rules for advisers and product providers.**

## Competition

A strong new regulator is not the only safeguard we need for financial services consumers – we also need to foster more effective competition.

Consumer organisations have warned about a lack of competition in the retail banking market.<sup>54</sup> Over the past two years the market has become even more concentrated. As a result of the crisis we have seen some of our largest high-street lenders merge with former rivals or disappear into Government ownership. Halifax Bank of Scotland, Northern Rock, Bradford & Bingley and Alliance and Leicester have all ceased to exist as independent competitors in the market.

Numerous mergers in the building society sector and the withdrawal of a number of foreign banks and specialist lenders has exacerbated the situation.<sup>55</sup> Between them, Royal Bank of Scotland, Lloyds Banking Group and Barclays hold 77 per cent of UK deposits and 40 per cent of UK mortgages - and a much higher proportion of new mortgages.<sup>56,57</sup> There is no debate that the market is now much more concentrated than it was a year ago.<sup>58</sup>

During the crisis it was in the public interest to prioritise stability over competition. However, in future years it is not clear that either financial stability or consumers will be best served by such a concentrated market.

We have already discussed means to tackle bank size where it presents a threat to financial stability. However we also need to consider the implications of a market dominated by a few 'super-banks' from a consumer and competition perspective.

The OFT has recently emphasised the need for a competitive financial services market arguing *"choice and competition involving existing players and new entrants are vital to delivering growth, prosperity and a good deal for consumers. There is a risk that this could be overlooked in the re-design of financial regulations, with high costs for consumers and the economy."*<sup>59</sup>

**A Conservative Government is committed to examining how to introduce greater diversity and competition into the UK banking sector. In the first instance a Conservative Secretary of State for Business will 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.**

The EU Commissioner for Competition has already warned that Lloyds Banking Group and Royal Bank of Scotland may be required to make significant divestments. The Commissioner's final decision will obviously have a bearing on any domestic review.

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**We are committed to divesting the Government's bank holding to strategic effect and in the wider public interest. The findings of the OFT and the Competition Commission will help to inform a Conservative Government's ongoing strategy for disposing of its banking shares.**

**The banking sector could benefit from more diversity. We will examine the case for new institutions similar to the old ICFC (which became 3i) to improve the supply of lending and equity capital to SMEs. We will also look at measures to enlarge the activities of credit unions.**

### *New Banks*

We also need to examine barriers to entry which may be preventing new players entering the building society and banking market. In many respects now would be the ideal time for a new institution to enter the market – a well capitalised institution unencumbered by legacy assets would be in a very strong position.

In the US the state-based structure of the banking market means that the barriers to entry are much lower, and in the past year many new banks have been formed in America. There has been no such similar influx in the UK market.

In their latest report on the banking crisis the Treasury Select Committee highlighted the problems of barriers to entry in the building society sector. Evidence from Adrian Coles, head of the Building Society Association, suggested that establishing new building societies is now harder than it was when the last new society (Ecology) entered the market in 1981.<sup>60</sup>

While it is obviously imperative to ensure that any new banks are sound and run by fit and proper individuals, we should look at how it might be possible to streamline the approval process in order to encourage new entrants.

**A Conservative Government will review whether legislative or regulatory reforms are required to encourage the creation of new building societies, banks, credit unions and community banks**

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- <sup>1</sup> IMF, Global Financial Stability Report, April 2009.
- <sup>2</sup> Bank of England, Financial Stability Report, June 2009
- <sup>3</sup> IMF, 'Households hit hard by wealth losses', 24 June 2009
- <sup>4</sup> *The Guardian*, 4 November 2006
- <sup>6</sup> Reinhart and Rogoff, Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historical Comparison, 2008
- <sup>7</sup> FSA, 'The Turner Review', March 2009
- <sup>8</sup> Speech 'A different vision for the economy', 6 March 2009
- <sup>9</sup> *Hansard*, 11 November 1997
- <sup>10</sup> Mervyn King, Evidence to the House of Lords Select Committee on Economic Affairs, Q487
- <sup>11</sup> Lord Turner, evidence to the House of Lords Select Committee on Economic Affairs, Banking Supervision and Regulation, June 2009
- <sup>12</sup> FSA, The Supervision of Northern Rock: a lessons learned review, March 2008
- <sup>13</sup> Speech at the RSA, 8 April 2009
- <sup>14</sup> HMT, Reforming Financial Markets, July 2009
- <sup>15</sup> Mervyn King, Mansion House Speech, 17<sup>th</sup> June
- <sup>16</sup> Treasury Select Committee, Banking Reform, September 2008. p85
- <sup>17</sup> Mervyn King, Mansion House Speech, 17<sup>th</sup> June.
- <sup>18</sup> Mervyn King, Evidence to the House of Lords Select Committee on Economic Affairs, Q487
- <sup>19</sup> President Obama, 'Remarks By The President On 21st Century Financial Regulatory Reform', June 17<sup>th</sup>
- <sup>20</sup> President Obama, 'Remarks By The President On 21st Century Financial Regulatory Reform', June 17<sup>th</sup>
- <sup>21</sup> HMT, Reforming Financial Markets, July 2009, page 48
- <sup>22</sup> Treasury Committee Questionnaire for Paul Tucker, January 2009  
[http://www.bankofengland.co.uk/publications/other/treasurycommittee/appoint/tucker\\_january09.pdf](http://www.bankofengland.co.uk/publications/other/treasurycommittee/appoint/tucker_january09.pdf)
- <sup>23</sup> "As far as individual banks are concerned, we face some uncomfortable choices about the structure and regulation of our banking sector. If some banks are thought to be too big to fail, then, in the words of a distinguished American economist, they are too big." Mervyn King, Speech to Mansion House, June 17<sup>th</sup> 2009.
- <sup>24</sup> Andrew Haldane, 'Rethinking the financial network', April 2009. Haldane concludes: "Size matters. Historically, the safety net was perceived to be fur-lined for those above a certain size."
- <sup>25</sup> Andrew Haldane, 'Small lessons from a big crisis', May 2009.
- <sup>26</sup> RBS Interim Management Statement Q1 2009, P.34
- <sup>27</sup> Financial Stability Report, Swiss National Bank, June 2009, p. 9.
- <sup>28</sup> Quoted in Financial Times, Switzerland looks at cutting size of banks, 18 June 2009.
- <sup>29</sup> Mervyn King put this argument to the Treasury Select Committee: "the problem is that the wider banks, precisely because they are not regulated, will be able for most of the period to offer higher returns, and many depositors will not be strong enough to say to themselves "I don't think this is really prudent in the very long run. I will stick with my narrow bank." They will switch their deposits to the wider bank, those banks will be less well regulated, they will expand much more rapidly than the narrow banking sector, and indeed, they will become so big that when the crisis does come, the government will be forced to step in for concern about what will happen to the economy through a collapse of these big institutions." Treasury Select Committee, Banking Crisis; Volume I. Q2401
- <sup>30</sup> The G30 also recommends that systematically important banking institutions should be prohibited from sponsorship and management of commingled private pools of capital (hedge and private equity funds in which combine the banking institution's own capital with client funds). Group of Thirty, Financial Reform: A Framework for Financial Stability, January 2009
- <sup>31</sup> Independent, Joseph Stiglitz: You ask the questions, 24 March 2008.
- <sup>32</sup> "The Turner Review downplays the role that remuneration structures played in causing the banking crisis and does not appear to us to accord sufficiently high priority to a fundamental reform of the bonus culture". Treasury Select Committee, Banking Crisis: reforming corporate governance and pay in the City, May 2009
- <sup>33</sup> Speech at Harvard Business School, 8 April 2008
- <sup>34</sup> The Turner Review, 2009
- <sup>35</sup> Sir James Sassoon, The Tripartite Review; Interim Report, March 2009
- <sup>36</sup> Dominique Strauss-Kahn, Managing Director of the International Monetary Fund, Speech at the Banco de España, Madrid, Spain, December 15, 2008
- <sup>37</sup> FSB, About the FSB - Overview, retrieved on 8 June 2009
- <sup>38</sup> OFT, The roles and responsibilities of the Financial Services Authority and the Office of Fair Trading, July 2007
- <sup>39</sup> Under Section 19 of the Financial Services and Markets Act 2000 (FSMA), any person who carries on a regulated activity in the UK must be authorised by the FSA. Regulated activities are set out in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO) and include: accepting deposits; issuing e-money; effecting or carrying out contracts of insurance as principal; dealing in investments (as principal or agent); arranging deals in investments; arranging, entering, or administering home finance activities; managing investments; assisting in the administration and performance of a contract of insurance; safeguarding

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and administering investments; sending dematerialised instructions; advising on investments and on home finance activities.

<sup>40</sup> Under section 21 of the Consumer Credit Act 1974, a business must have a credit licence issued by the OFT to carry out certain activities in the fields of consumer credit and consumer hire. Credit is defined in sections 8-16 of the 1974 Act. Businesses require a consumer credit licence if they: sell goods on credit; hire or lease out goods for more than three months; lend money; arrange credit for others; offer hire purchase terms; collect debts; help people with debt problems; advise on people's credit standing; administer agreements (but do not collect debts) on behalf of creditors (in the case of consumer credit) or owners (in the case of consumer hire); help individuals to locate (and possibly also correct) records about their financial standing held by credit information agencies

<sup>41</sup> In 2007 21,000 firms were regulated by FSA and OFT, this is 76% of the total 27,340 firms that were regulated by the FSA. OFT & FSA, 'Delivering better regulatory outcomes – May 2008 update'. May 2008, FSA Annual Report 2007/08

<sup>42</sup> Speech to FSA Mortgage Conference, May 2009. The Financial Services Consumer Panel has made a similar point: "We believe that prior to the crisis the relationship between the regulator and the regulated was not sufficiently challenging and we believe that the relationship should be based on policing rather than partnership". Response to the Turner Review, June 2009

<sup>43</sup> OFT & FSA, 'Delivering better regulatory outcomes – May 2008 update'. May 2008

<sup>44</sup> These are currently delegated to the Banking Code Standards Board (BCSB) however will be passed to the FSA in November 2009.

<sup>45</sup> Financial Services Consumer Panel, The Turner Review; A Response From The Financial Services Consumer Panel,, June 2009

<sup>46</sup> The draft Consumer Protection Act 2009 includes the following: "Subject to rules prescribed by the Agency, a covered person shall make available to a consumer information in the control or possession of the covered person concerning the consumer financial product or service that the consumer obtained from such covered person including information relating to any transaction, series of transactions, or to the account including costs, charges and usage data. The information shall be made available in an electronic form usable by consumers." Section 038, Consumer rights to access information.

<sup>47</sup> David Cameron launched this policy which was welcomed by, among others, the Consumer Credit Counselling Service - the UK's leading debt advice charity: "CCCS welcomes the Conservative commitment to funding and developing free money guidance. The need is there among the whole community." Chairman and founder of CCCS, Malcolm Hurlston

<sup>48</sup> Amanda Pinto QC: "There are many cases of misconduct that the FSA has pursued as regulatory breaches where the evidence suggests that these offences are both substantial and criminal, such as fraud and misleading conduct. These cases could be prosecuted in the criminal courts, yet the FSA chooses to deal with them as if they were simply regulatory infringements." FT Adviser.

<sup>49</sup> Which? point to the £7 million fine imposed on Alliance & Leicester in October 2008 for "particularly serious" breaches of the PPI rules. This compares to revenues from PPI sales, over the relevant period, of more than £260 million. They contrast this with fines for Argos and Littlewood of £22 million for price fixing of toys and for Severn Trent Water of £35.8 million for misreporting information and providing substandard service.

<sup>50</sup> See David Cameron's speech, 'A day of reckoning', 15<sup>th</sup> December 2008

<sup>51</sup> "In Britain, no one has any confidence that fraud in banks will be prosecuted as crime. But it is absolutely critical to public confidence that it should be... So we need a single powerful authority to take the place of the failed Financial Services Authority and the embattled Serious Fraud Office. Independent and strong, it should have responsibility for both regulation and prosecution". Sir Ken Macdonald, The Times, February 2009

<sup>52</sup> Conduct of Business regulators in Australia and the Netherlands both take on responsibilities beyond consumer protection. The main additional role for both of these regulators is as lead supervisor and licensing authority for securities institutions. They also both retain a duty to combat financial crime and a responsibility for financial education.

<sup>53</sup> Firms in this division submit regulatory data far less frequently than their larger counterparts. And while larger firms are likely to receive regular on-site "Arrow" visits from their FSA supervisor (sometimes annually and sometimes less frequently) and banks would have very frequent visits from their regulator, firms supervised in the Small Firms and Contact division are usually subject to desk-based "baseline monitoring" - which in practical terms means monitoring of their regulatory returns and following up on any areas which appear to have changed significantly or appear outside the expected range for their peer group. If a firm in this division has a regulatory question they would make contact with the FSA via the contact centre (rather than via a dedicated supervisor). This reflects the general view that the FSA can answer regulatory questions for these smaller and simpler firms without having a detailed knowledge of the firm's activities.

<sup>54</sup> Which? warned the Treasury Select Committee that "our long-standing concerns about the lack of effective competition in the retail banking sector have been significantly increased by recent changes in market structure. While accepting the importance of preserving stability as a priority, specific measures are needed to ensure consumers are not adversely affected in the future." House of Commons Treasury Committee, Banking Crisis, Volume II. Ev 237.

<sup>55</sup> For example: in September 2008 Nationwide, The Derbyshire and The Cheshire agreed to merge, in October 2008 Barnsley Building Society agreed to merge with Yorkshire Building Society and in November 2008 Skipton Building Society agreed to merge with the smaller Scarborough Building Society.

<sup>56</sup> British Bankers Association Annual Abstract 2008; figures based on 2007 financial structure

<sup>57</sup> CML Statistics, Table MM10. Figure based on total mortgage balances outstanding, end year 2007.

<sup>58</sup> As Angela Knight, head of the British Banking Association, has said, the market is now "much narrower" than it was a year ago. Angela Knight, Evidence to the Treasury Select Committee. House of Commons Treasu Committee, Banking Crisis;

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Volume 1; Oral Evidence. Q888.

<sup>59</sup> Office of Fair Trading Press Release, OFT consults on financial services strategy, April 7<sup>th</sup> 2009

<sup>60</sup> “It would not be possible now, unfortunately, under the regulations today to set up the Ecology Building Society because the minimum capital required by the regulation is a million pounds. How do a group of ecologists get together a million pounds? They would not be able to do that now. The one area of growth of financial mutuals is credit unions. It is difficult to see under current regulations how a new building society could be established unless there was scope to turn a large credit union into a building society, and there is no legislative scope to do that at the moment.” Treasury Select Committee. Banking Crisis; Volume I; Oral evidence. Q1608





