The UK approach to financial regulation

*The **Governor** discusses[1] the philosophy underlying the measures being taken to reform the regulatory system in the United Kingdom and their role in maintaining the position of London as an open but well-regulated financial centre.*

*The two major pieces of legislation now in prospect—the Financial Services Bill already before Parliament and amendments to the 1979 Banking Act—have a number of common themes which are as important as their more obvious differences. In particular, central to each is the capacity to adjust to future changes and the flexibility to take account of the diversity of business: and the weight given to practitioner expertise and practitioner advice is an important element in achieving this. The **Governor** argues that regulation that is both flexible and thorough should be more effective in preventing malpractice as well as providing scope for innovation and market development, but emphasises also the need for an effective system for the detection and prosecution of fraud. Finally, he goes on to argue that the few highly publicised failures need to be set in their proper perspective, against the City's success in meeting the test of providing the best service to customers.*

Our President has referred to the presence in this great Guildhall of the traditional defenders of the City—Gog and Magog. They are with us, of course, each year. But it is a particular honour to have with us on this occasion a different giant, and a formidably effective defender of the international monetary and financial system, in the person of Jacques de Larosière. There can be no-one who has been close to the international debt situation as it has unfolded over the past few years who has not admired his skilful and patient diplomacy and the courageous leadership he has shown in leading us towards practical solutions to the problems we are all facing.

In his remarks tonight he has again displayed those virtues, by analysing the achievements and pointing up the risks. I share his concerns and very much agree with all that he has said about what we should be doing and where we should be heading. In particular, a recent visit I made to Latin America has reinforced my conviction that we will solve the debt problem only on the basis of shared responsibility and co-operation.

If indeed this is to come to pass, we need effective capital markets worldwide. One of these must be London and it is on London that I wish to focus attention tonight. The number of overseas banks permitted to take deposits in the United Kingdom is 340; and there are a further 150 banks which have representative offices in London. Many of these banks, of course, are represented here tonight. Their presence is living proof of the continuing success of London as an international financial centre.

To build on that success in the current period of rapid and radical change, London will have to maintain its reputation not only for competitiveness but also for integrity. I am confident that the approach being adopted in reforming the regulatory system is well designed to meet these objectives.

Two major pieces of legislation will introduce these reforms—the Financial Services Bill now being considered in Committee in the House of Commons, and the Bill to amend the 1979 Banking Act which the Chancellor intends to introduce in the next parliamentary session. There are obvious differences between the regulatory systems established by the two bills. On the one hand the current banking legislation confers powers on one authority, the Bank of England, to exercise prudential supervision over banks in order to protect depositors, and this will continue. Under the Financial Services Bill, on the other hand, the Secretary of State for Trade and Industry will transfer powers to an agency which will in turn oversee a group of recognised self-regulatory organisations: their objective will be to protect investors by regulating the conduct of investment businesses in their dealings with clients and counterparties. But the similarities between the two systems, and the common philosophy underlying them, are as important as the differences.

First, in spite of recent public and parliamentary attention, neither is nor should be seen simply as an instant reaction to political pressures. The banking proposals take account of six years' practical experience with the 1979 Banking Act. The Financial Services Bill has effectively been in gestation from the time when, four and a half years ago, Professor Gower was commissioned to undertake his review of investor protection, and there has been an almost continuous process of consultation over that period. The bill will create a thorough system of regulation of a much

(1) In a speech to the Overseas Bankers' Club on 3 February.

wider range of investment activities than has been covered by previous legislation dating from a time when the range of financial products on offer to the public was a great deal smaller.

Second, just as both pieces of legislation will incorporate the lessons of past experience, so they will also maintain within the regulatory system a built-in capacity to adapt to future changes in market structures and practices. A feature of our banking supervision is the absence of detailed statutory prescriptions and rules for the prudential behaviour of banks. This allows the Bank of England to take account of the diversity and evolution of banking business—as we did last year with regard to the prudential treatment of revolving underwriting facilities and intend to do in dealing with the whole range of new off balance sheet transactions.

Similarly, the Financial Services Bill lays down principles of business conduct which it leaves to the regulatory agency to convert into more detailed rules. In most cases, moreover, the agency and the recognised self-regulatory organisations will have some latitude to vary the application of the rules to fit the characteristics of particular markets and different categories of customer. In particular, it will be feasible to make distinctions between retail transactions with private investors and wholesale transactions with financial institutions and other professional operators. The latter are in a better position to make their own judgements about the quality of services which they buy, balancing such factors as information, cost, liquidity and risk of counterparty failure against each other. That is not to say that they deserve no protection, but it will probably be reasonable to apply less rigorous requirements, on, for example, disclosure, to wholesale transactions in markets such as the money markets, the eurobond market, and the commodity futures markets, than those applied to retail transactions.

This question of the appropriate intensity of regulation calls for the kind of judgement which practitioners close to particular markets will be best qualified to contribute. A large input by practitioners and by representative market users is, indeed, an essential element in the regulatory system envisaged in the Financial Services Bill—and the characteristic which, perhaps, most distinguishes it from the systems with which many of you will be familiar in your domestic markets.

So far as deposit-taking is concerned, the situation is a little different. It is the Bank of England and its permanent staff which are charged under the Banking Act with specific responsibilities. We are seeking, by increasing the number of inward and outward secondments, to ensure that the staff engaged in supervision have practical commercial experience. Thus, just as in the past with Exchange Control, our approach to banking supervision has been informed by a keen appreciation of market realities. This will be enhanced by the creation and composition of the new Board of Banking Supervision, which will give important recognition to the value which I place on practitioner advice.

A further common theme of both regulatory systems will be the role which auditors will be expected to perform. Too much attention has been given to those occasions, which are likely to be rare, when an auditor will need to make a confidential report to the authorities. In practice we will chiefly be looking to the auditors to scrutinise and comment on the effectiveness with which financial businesses maintain their internal control and reporting procedures. Nevertheless it is the supervisors who must retain the final responsibility for judging whether banking and investment businesses continue to satisfy the standards demanded by the legislation.

In emphasising the need for regulatory systems to be flexible as well as thorough, I have in mind both the negative and the positive sides of regulation. On the one hand there is the need to prevent malpractices and root out offenders. There is reason to believe that self-regulatory organisations operating non-statutory rules should be more effective in this respect than statutory bodies staffed by civil servants. The speed with which The Stock Exchange has moved in the past to suspend or expel offenders is powerful evidence of this. I believe the regulatory system being constructed will preserve and enhance this capacity for swift disciplinary action.

The new regulatory arrangements will of course need to be underpinned by an effective system for the detection, prosecution and conviction of financial criminals. I know of no system which can be guaranteed to prevent fraud. But any regulatory system, statutory or non-statutory, official or self-regulatory, will be weakened if confidence is lacking in the ability of the prosecuting authorities and the courts to bring the fraudulent to justice. I strongly welcome, therefore, the recent recommendations of the Committee chaired by Lord Roskill, and the urgency with which the Government is considering them.

The positive side of the regulatory reforms will be found in the encouragement they give to high standards of conduct in financial markets, and the scope they provide for innovation and market development. In this sense, regulation is a means to the greater end of continuing to attract international business to London as an open but well-regulated financial centre.

I recognise that this is quite a difficult balancing act to achieve. While we are setting up a new regulatory system the costs to market operators may be more obvious than the benefits; and the commitment to it which is being required of practitioners may seem an unwelcome distraction at a time when they are already intensely occupied with changes in market structure and new forms of competition. But if there currently appears to be too much emphasis on regulation, there should be no long-term unnecessary restriction of competition.

The crucial test, both domestically and internationally, will be success in providing the best service to customers. Measured against that test, the financial institutions of the City of London—in banking, in fund management, in insurance, and in the foreign exchange, securities and other financial markets—are continuing to prove their ability to succeed.

Against this perspective, we can set in their proper place a few highly publicised failures. Several of these cases have only the most tenuous connection with the City of London. To some critics and commentators any financial fraud is City fraud, and no effort is made to distinguish between fraud on a financial institution, fraud by an institution, and fraud on others committed by customers of an institution. Failure to make distinctions of this kind has been particularly evident in the reporting of the case of Johnson Matthey Bankers. After eighteen months of intensive examination, it appears clear that the losses made by that bank were overwhelmingly due to inadequate lending control. I would also remind you that this was the only one out of 300 recognised banks in London which has got into serious difficulties in recent years—a record which compares well with that of other financial centres.

Recent criticisms of Lloyd's need also to be placed in context. It cannot be denied that in the seventies standards of conduct by some Lloyd's members slipped below those which we were entitled to take for granted, and that in a few notorious cases they fell further still from the unacceptable to the fraudulent. The exposure and prosecution of these past abuses is proving a long drawn out and traumatic experience for Lloyd's. But it is important to remember that these events predated the Lloyd's Act 1982 and that Lloyd's has never failed to meet valid claims on its policies. Policy-holders are after all the intended prime beneficiaries of insurance legislation, just as depositors are of banking legislation, and small investors are of the financial services legislation. The victims have been those who pledged their wealth to the risks of underwriting syndicates without limited liability. I welcome Sir Patrick Neill's enquiry into the workings of the Lloyd's Act as an opportunity to examine whether Lloyd's present structure offers them that degree of protection which is appropriate to the unusual nature of their investment.

I have one final message which I wish to convey tonight. While supervisors and regulators must use their full array of powers and techniques to see that financial institutions conduct their business properly and competently, they cannot usurp the role of management or the responsibility of Boards of Directors. They can materially help to reduce the likelihood of failures, but they cannot replace the need for skill and judgement in taking market risks—indeed it would suggest a certain lack of competition and of enterprise if they could.

In conclusion, then, Mr President, I believe that the regulatory changes now in preparation are well suited to our great financial centre at a time of continuing change. They will help to foster the conditions in which high standards can thrive; and in which the City of London can continue to flourish.