Financial regulation: why, how and by whom?

*The **Deputy Governor**[1] considers three questions: why regulate financial institutions?; how should financial regulation be conducted?; and who should be responsible for doing the job? On the first, he explains that the Bank of England, as banking supervisor, views reducing the risk of individual bank failure as its essential supervisory task, but that—in view of banks' economic function as risk-takers and also the need to avoid moral hazard—depositors must accept that the possibility of such failure cannot be entirely excluded. In examining the manner in which regulation should be conducted, the **Deputy Governor** reviews the familiar tools such as capital requirements, but also considers the insights on best practice learned from the Bank's own review of supervision. Finally, he considers the case for reform of the regulatory structure in the United Kingdom. He argues that any structure should take account of the fact that banks remain a distinctive type of institution, and stresses that the priority is co-operation among regulators based on a clear understanding of responsibilities and the free flow of information.*

I have given myself rather an ambitious title today. This reflects the fact that the Bank of England has recently conducted a review of banking supervision with the help of Arthur Andersen. We published their findings and our response to them in July. In the course of the Review we thought in some detail about how the practice of financial regulation—and specifically banking supervision—should react to the rapidly changing external environment. Financial groups are becoming more complex and more global. How should supervisors respond? If banks and securities houses merge, or an insurance company starts a bank, as the Prudential and others have done, what sense does it make to have a number of separate regulatory structures? Is that not less efficient, and more costly than one single, all singing all dancing mega regulator?

Others argue that in this new world, while a single regulator might not make sense, we should nonetheless cut the cake a different way, and distinguish clearly between prudential regulation, on the one hand, and conduct of business regulation on the other.

I would like to try to unravel this complex set of issues by considering three questions: why regulate financial institutions at all; how should financial regulation be conducted? and, finally, who should be responsible for doing the job?

Why regulate financial institutions?

At one level, the answer to this question is well rehearsed. Financial regulators collectively have four objectives: to protect the economy against systemic risk; to protect individual depositors, insurance policy holders and even, to some extent, investors against loss; to protect customers against business misconduct; and finally to protect society at large against crime, for example through ensuring that financial firms have systems in place to detect and report laundered drug money or other proceeds of organised crime. I shall limit myself to considering the first two of these this evening, since they are the prime responsibilities of the Bank.

But, even then, we appear to have a daunting—not to say impossible—task. How can any regulators offer a blanket assurance to depositors and investors that their money is safe? The truth is that they cannot. And, after all, in financial as in other markets, there is a role for the principle of *caveat emptor*. So there is an important balance to be struck between the responsibilities of regulators on the one hand, and those of depositors, investors, insurance policy holders and their advisers on the other. And while we must always be conscious of the need to maintain confidence in the financial system, we are (and must be) in the business of offering a degree of, rather than complete protection for, the individual depositor.

The explanations for the limits to regulation are twofold: practical and theoretical. We must try to do both 'what is possible', and 'what is right'. The practical limits (what is possible) relate to the tools available, and hence to how regulation is carried out—I will return to this later. The theoretical limits (what is right) relate to the rationale for regulation.

I said I would consider just the first two objectives of regulation—to protect the economy against systemic risk; and to offer a degree of protection against loss to individual depositors, investors and insurance policy holders. In this context, the Bank of England—as banking supervisor—views reducing the risk of individual bank failure as its essential supervisory task. However, it is quite clear to us that we are not required, and should not be required, to prevent all bank failures. To do so would require either a

[1] In the Sixth Anthony Howitt Lecture delivered on 2 December 1996 at the Chartered Institute of Management Accountants.

damagingly tight constraint on risk-taking by banks or essentially open-ended support from the public sector. Alan Greenspan, Chairman of the Federal Reserve in Washington, made a similar point in a speech in Stockholm in May this year, when he said: 'we should not forget that the basic economic function of these regulated entities is to take risk. If we minimise risk-taking in order to reduce failure rates to zero, we will, by definition, have eliminated the purpose of the banking system'. The same view would be taken by securities regulators.

There is also a second, moral hazard, argument against watertight supervision. If the state guarantees the existence of individual banks, that can create incentives which encourage irresponsible behaviour. The prize for taking excess risk may—if things go well—be excess returns (and telephone number bonuses) while, if things turn out badly, the state steps in and picks up the tab. This is known as a one-way bet. It would prove as costly for the central bank—and ultimately the taxpayer—as Frankie Dettori's seven winners were for the turf accountants.

The same moral hazard argument applies to deposit protection schemes. Compensation arrangements specifically allow for institutional failure—but with co-insurance. Only 90% of a bank deposit is insured, and there is a maximum payout per depositor of £18,000. Limits also apply in the case of investor compensation. So depositors are still encouraged to assess the riskiness of the institutions with which they deal. That therefore adds a degree of market discipline, which will probably be faster acting, and more effective, than the efforts of regulators.

But of course the Bank of England wears two hats. Having as supervisors tried to limit the risk of failure, when faced as central bankers with such failure, we must then consider whether or not to offer assistance. When making this decision, the overriding principle is that any action must be directed at safeguarding the financial system and therefore preventing damage to the wider economy. Beyond that, we apply five rules:

- first, we explore every option for a commercial solution before committing our own funds;
- second, we seek to avoid any subsidy to private shareholders;
- third, we aim to provide liquidity to solvent institutions rather than supporting an insolvent one;
- fourth, we look for a clear exit; and
- fifth, we usually try to keep the fact that we are providing support secret at the time, to avoid destabilising other firms.

And, as events over the last few years have suggested, all this means that we do not have a list of institutions which are eligible for last resort assistance. In the early 1990s, we provided help to a number of small UK banks, where we believed market sentiment at the time was such that their failure could have widespread consequences for confidence. By contrast, in 1995 we took the view that the possible failure of Barings Bank did not have systemic implications.

We are quite clear, therefore, that depositors and investors must accept that failure is, from time to time, to be expected in financial markets, just as it is in the retail sector, or—sadly—among football clubs. But the public also has the right to expect supervisors and regulators to be active on their behalf. They expect eyebrows to be raised, whistles to be blown, and red cards to be waved aloft, from time to time. And they are right.

This brings me to my second question:

How should financial regulation be carried out?

As with question one, the answer lies in part in familiar territory. Focusing once again on the first two regulatory objectives, regulators set capital requirements to cover the more readily quantifiable risks; they produce rules on firms' liquidity; they enforce limits on the scale of exposure to individual counterparties; they conduct consolidated supervision—considering the impact of the rest of the companies in a financial group on the health of the regulated entity; and they seek to ensure that firms have robust systems and controls.

Most fundamentally, perhaps, regulators can ask questions, and attempt to take advantage of all the information at their disposal to form a judgment of the risks facing depositors, investors, insurance policy holders etc, and of the quality of an institution's management. In addition to enforcing rules and looking for problems, they can therefore help management. They can spread knowledge of best practice: asking firms about the full range of risks they face (including those—like reputational and settlement risk—that they would often rather ignore); pointing out to complex groups the extent to which their managerial and organisational systems have moved away from their legal structure; spotting signs of fraud or money laundering; and revealing gaps in management's understanding of new financial instruments. Through speaking to a wide range of institutions, they notice differences in the way risks are viewed, managed and priced and can challenge managers to justify their particular perspectives. This then is the familiar answer to the question 'how should financial regulation be carried out?'—although some may be surprised to hear me refer to the potential benefits to management.

The Bank's Review of Banking Supervision

But putting it all into practice is not easy.

That is why we carried out a review of banking supervision this year to examine whether we were keeping up with best supervisory practice. Arthur Andersen talked to four other

UK financial services supervisors and regulators, and to nine overseas banking supervisory authorities, and put marks on benches on our behalf.

They found that regulators everywhere were asking themselves the same questions. In particular, they were all preoccupied by the question of how to set an appropriate balance between rules and judgments. Should supervisors simply set the rules, and shoot those who break them? Or does that create too rigid a framework, one which stifles initiative and imagination? There is no simple answer to that question. The Bank of England imposes an increasing number of rules; it has, for example, implemented regimes for capital adequacy introduced by the Basle Committee and by the EU. But our judgmental, flexible approach—what Arthur Andersen described as 'the discretion given to supervisors to exercise informed judgment within approved guidelines'—still contrasts with that of many other regulators.

That contrast is, however, by no means as stark as once it was. The Arthur Andersen Review showed that the traditional caricatures of different regulators no longer reflect reality. In a fast moving marketplace characterised by rapid product innovation, other supervisors—who traditionally, as in the United States, operate a rulebook—are moving towards a regime that gives more scope for supervisory judgment. At the same time, the Bank has recognised the need to be more systematic in its risk assessment and has announced its intention to introduce a more formal approach based on a common 'model', known as the RATE model, to identify, using a series of qualitative and quantitative measures, the risks faced by the institution. So there is convergence between regulators—even without the discipline of Maastricht-imposed criteria!

The debate about rules and judgment is viewed by some to be synonymous with the debate about on versus off-site supervision. It is true that, in addition to being viewed as less rule-bound than other supervisors, the Bank is commonly viewed as doing relatively little on-site supervision.

Of course, this depends on how you define the term. Accountants are well aware that the Bank does, for example, make extensive use of reports prepared by auditors—who, of course operate on-site—in order to assess the adequacy of internal controls. In particular, the Bank regularly instructs banks to appoint reporting accountants to report on systems and controls and on the accuracy of prudential returns. And we talk to both internal and external auditors, and banks' Audit Committees. But Arthur Andersen thought we should do more. In particular, they suggested that a more systematic approach to risk assessment should help supervisors to target reporting accountants' work more precisely and to ask the most appropriate questions of auditors. We are looking now at just what this would mean in practice and will publish some proposals for change early in 1997. On which, of course, we will consult the profession.

The Bank's supervisors also do a growing amount of work on-site. Since 1986, a team (including accountants seconded to the Bank) has carried out *ad hoc* focused on-site reviews, and in 1995 we introduced a Traded Markets Team to inspect the models institutions use to measure market risk. Following the Arthur Andersen Review, we have decided to increase the amount of time spent by supervisors on the premises—as this will enhance their knowledge of the business and enable them to meet and talk to a far wider range of the staff. There is no intention that this should amount to 'inspection' in the old-fashioned sense. We don't want our supervisors to spend their lives putting ticks in boxes.

Indeed we are still very committed to a style of supervision which relies critically on the high quality both of our staff and of the supervisory tools that they have available to them. Arthur Andersen commented that, both domestically and internationally, the Bank's supervisors have a reputation for their intellect, dedication and spirit of public service. But supervised institutions also said that the Bank's staff lacked commercial awareness and detailed market knowledge. A comparison with the staffing profile of overseas supervisors also showed that our staff had less relevant experience outside the Bank or as supervisors than their major overseas counterparts.

In part, this reflects a debate about the role of specialism which the Bank has faced and which is common to many other organisations. As the skills needed to be a supervisor become more technical, so the need for 'specialist career supervisors' increases. On the other hand, career central bankers with experience in other parts of the Bank—for example, working in the markets or payments areas—bring valuable additional insight to supervision. One means of enhancing the stock of specialist skills is to 'buy-in' specialisms as and when they are needed. In a sense this is what the Bank does regularly with auditors, but what it has also done to some extent with the Traded Markets Team. However, the skills are often bought in in the hope that they will be transferred to existing staff. In common with other supervisors, we have found achieving such a transfer to be hard.

We are determined to solve this problem. We have therefore decided to increase the average length of time which our own staff spend in supervision before moving to other areas of the Bank. We have also decided to strengthen further the existing team of treasury and capital market specialists, and to ensure that our Review teams mentioned earlier are more closely integrated with the line supervisors that they advise.

Whether they are career supervisors or not, all staff require training. In common with other large organisations, the particular challenge is to create a culture of continuous learning and to ensure that training opportunities are available throughout an individual's career. Arthur Andersen were entirely right to say that this was the key requirement. One important aspect is providing opportunities for outward secondment to banks, so that supervisors can experience a commercial environment, and can—for example—learn about risk management in practice. We hope to boost our secondment programme substantially in the near future, and hope that we will receive support from the financial community in achieving that.

Trained, high calibre staff do, of course, need the tools to do the job. As supervisors one of our key comparative advantages—perhaps the most important one—is that we can make comparisons between institutions and analyse the trends in 'peer groups'. We may not be able to pay 'top dollar' salaries in the marketplace, but we do have one advantage over the banks which can. Our people have access to and direct knowledge of the management approaches and risk measurement techniques of all institutions in the City. But of course this access, this information, is only valuable if we can make effective use of it. That is not a trivial challenge. We found in the course of the Review that we had spent relatively little on IT over the recent past when compared with other supervisors. Less than 5% of our total costs, versus up to 30% elsewhere. We have therefore announced a major new investment combined with the establishment of a special unit responsible for data administration and organisation.

All this amounts to a major programme of work to ensure that the Bank remains an effective banking supervisor, as long as we have that responsibility. Which brings me to my third question:

Who should conduct financial regulation?

In this case, it is fair to say that familiar or well-rehearsed answers are rather harder to come by. Few would argue over the nature of the problem: as financial groups have become more complex (incorporating a range of different financial businesses) and have begun to operate on a global basis, they have acquired a bewilderingly large number of regulators. In discussion with one large clearing bank here recently we established a list of over 150 different regulators, in the different jurisdictions in which they operated, before we gave up counting and went to bed.

It is hard to believe that represents the ideal regulatory framework. Even speaking as a regulator myself, I would have to accept that you can have too much of a good thing.

However, the search for a solution is proving problematic. The complex institutional structure of regulation reflects, at least in part, the fact that the financial services industry comprises a number of separate businesses (each needing to be regulated in a distinctive fashion), while many firms also conduct more than one type of business. As a result, the apparently simple solutions of one regulator for each type of firm or for each type of business do not provide a complete and tidy answer. In the first case, you run the risk that two firms carrying out identical business are regulated differently. In the second case, no one regulator has responsibility for setting capital charges for the firm as a whole.

But this is not a knockdown argument against any change in the regulatory structure in the United Kingdom. What of the argument I referred to at the start, that it would nonetheless be an improvement to cut the regulatory cake a different way? That the business of banks and securities firms has become sufficiently intertwined and indistinguishable that one regulator of both banks and securities houses would make better sense?

I must say that we are not persuaded. Certainly there has been a degree of convergence between banks and securities firms. Banks now own what we used to call jobbers and stockbrokers. Securities firms own banks, though generally relatively small ones (and of course not within the United States). But, in our view, there is still a reasonably clear distinction to be made between banks and other financial institutions, and their prudential soundness, or lack of it, can have rather different implications for the rest of the market.

Most particularly, in order to perform their economic function, banks engage in a high degree of maturity transformation: that is one of their prime economic justifications. They turn short-term deposits into long-term loans. So that a comparison of the balance sheets of major British, or American commercial banks, with those of the major securities firms, shows a very clear difference in their asset and liability structure. There is a much greater mismatch of maturity on a bank's balance sheet, than there is on that of a securities house.

Furthermore, banks—unlike securities houses—are at the heart of the payments system. Their failure can therefore have a very direct and profound impact on the wider economy.

We continue to take the view that banks are a unique type of financial institution. That is not to say that market evolution may not mean that, in due course, the case for merging banking and securities regulators became stronger. But that is not where we are and indeed I note that the Labour Party are not making proposals to that effect in their own thoughts on the structure of regulation. Nor did the Treasury Select Committee in their most recent report.

Of course it may be argued that the distinctive characteristics of banks, and their potential to create systemic risk—which central banks can counteract—does not necessarily mean that the central bank should act as their regulator. I agree. But there are significant synergies to be had from maintaining an institutional link between the two functions, and the burden of proof rests, I think, with those who wish to make the case for disturbing that relationship.

There have also been arguments for change in the Financial Services Act area where currently the Securities and Investments Board is responsible for the integrity of markets, and for setting the framework within which the frontline regulators operate. Here the Labour Party have proposed that the SIB should absorb the existing self-regulatory authorities, the PIA, IMRO and the SFA. This is not directly my business even though I am now a member of the Securities and Investments Board. The Board itself has taken the view that legislative change is a matter for Parliament, and that it will operate within whatever regulatory framework is laid down. But it may well be that, in some areas, consolidation would make co-operation easier to achieve.

There is another proposal involving radical change to the United Kingdom's regulatory structure which has received some attention recently known now as 'Peak Practice'. (It started life as 'Twin Peaks'.) This involves the creation of two 'Commissions' each reporting directly to the Treasury. The first (called a Financial Stability Commission) would focus on systemic risk and would be responsible for the prudential supervision of banks, building societies, securities houses, institutional fund managers and insurance companies, and also for the conduct of wholesale business. The second (called a Consumer Protection Commission) would focus on conduct of business and would be responsible for fair dealing between financial institutions and retail clients, and for the detection and prosecution of insider dealing and of market manipulation. It would also look after the prudential supervision of private client fund managers, financial advisers and small stockbrokers.

The argumentation behind the proposal is considered and thoughtful. But we are not convinced that the substantial upheaval and cost involved would be warranted. The model assumes both that a very wide range of firms are systemic and that all systemically significant firms should be regulated by the same institution. By contrast, we believe that banks remain unique in this respect (at least for the time being) and, were a single institution to conduct prudential supervision for everything from banks to insurance companies, it would still need to tailor the rules to meet the characteristics of particular types of business. In effect the new regulator could quickly become a collection of separate 'Divisions'. There is also an apparent gap, as the regulation of markets themselves does not fit into either Commission. So we are already up to three peaks. Meanwhile the costs of change would be substantial. The new commissions would not evolve easily out of any existing regulator. All financial firms would have a new regulator (two in most cases). They are unlikely to welcome that. And the synergies I alluded to earlier between the supervisory and lender of last resort activities of the Bank would be lost.

All these changes would require legislation. And, for the time being, no legislative proposals are on offer. So while it is always entertaining to debate structural change, and it may be that in due course structural change is what we have, it would be a shame if the debate diverted us from what we need to do. Our own efforts now are focused in two directions. These are to ensure, first, that, given the regulatory structure, costs are minimised, and, second, that co-operation between regulators is based on a clear understanding of responsibilities and the free flow of information.

Work on improving regulatory co-operation—at both a domestic and an international level—is currently intense. There is, as you would hope, already extensive contact between the Bank of England and the securities and insurance regulators in the United Kingdom. In particular, each financial group in the United Kingdom has a lead regulator and, where it contains a bank, this is usually the Bank of England. They convene regular college meetings to share information with the other UK regulators. At a different level, these links have recently been strengthened through cross membership between the Board of Banking Supervision (BoBS) and the SIB. As I mentioned, I am now on the SIB Board while Sir Andrew Large has joined BoBS. So, we have shown that there is no absolute requirement for legislation, if your aim is to improve information sharing.

At international level, attention has recently focused on the supervision of diversified financial groups. Indeed it was a topic addressed directly by heads of government at the Lyon summit in June. Subsequently, the Basle committee and IOSCO announced a joint initiative to strengthen co-operation between securities and banking regulators. The work will support that of the already established Joint Forum of banking, securities and insurance supervisors which has been set up to pursue practical means to facilitate information exchange, in addition to exploring other policy issues associated with the supervision of international financial conglomerates. And we have also been actively involved, along with the Americans, in some 'live' supervision work, looking at particular institutions and their practical problems. There are eight different regulators involved, three on this side of the Atlantic, five on that, so the meetings are naturally called quadrilaterals. Indeed most recently we have made life even more complicated by extending the work, under the auspices of the Joint Forum, to include other countries.

At the same time, supervisors of the world's leading futures exchanges have put in place a programme of work to strengthen the arrangements for supervising such markets and recently published an up-date of the work that was started at Windsor last year.

I would not wish to pretend that all this work, which generates information-sharing agreements and memoranda of understanding in an incontinent manner, will solve all problems of regulatory co-ordination. But I think that we are at least trying to move as fast as the marketplace, difficult though that challenge is.

And the marketplace is where I should end. It is time to stop. But it also the right place. Because we always need to remind ourselves that financial regulation is not a wealth-creating activity which has its own internal justification for existing. Its purpose is essentially to facilitate economic activity in the private sector, and to promote wealth creation by providing a framework of rules within which economic actors can operate confidently. In our view that means, as far as possible, a light touch. It argues for an approach based on the principle that market participants can do what they want unless we say that they can't, rather than that they can only do what we say they can. That inevitably means that every time there is some kind of failure in the market, people reassess the rules and—most commonly—argue that they require further tightening. Sometimes that is justified, but just as often it is not. I have tried today to explain how we have sought to draw the lessons from the Barings collapse, to strengthen regulation where needed, but without imposing further unjustifiable burdens. You will all have your own views as to whether we have set the dials correctly.