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Regulatory Reform in the U.K.

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Since the Global Financial Crisis first developed in 2007, both the United States and the United Kingdom have embarked on ambitious programs of regulatory reform that have placed them at the forefront of the international “re-regulation” of finance. The U.S. and U.K. have been among the chief drivers of the international process of re-regulation that has been conducted in networks of international standard setting bodies such as the Basel Committee on Banking Supervision and the Financial Stability Board. However, even within a framework of broad agreement within the international standard setting process, there are differences between the British and U.S. approaches that reflect both industry structures and domestic political factors. In this essay, I will concentrate on the two major dimensions of the U.K.’s reform program where these differences are especially evident: the institutional structure of regulation, in particular the adoption of the so-called “Twin Peaks” structure, and the approach to ending the “Too Big to Fail” (TBTF) problem. With respect to the first of these dimensions, the regulatory response to the financial crisis in the U.K. reflects a very different institutional starting point to that of the U.S., since the reforms have involved the de-merger of a single regulatory agency, and the return of powers to the central bank, in contrast to the agency consolidation found in the U.S. There are greater commonalities between Britain and the U.S. in their recognition of the TBTF problem and of the policy measures needed to address it, but here too issues of domestic political economy have exerted a powerful influence in shaping post-crisis regulatory efforts.

I. INSTITUTIONAL STRUCTURE OF REGULATION

One of the most eye-catching elements of the U.K.’s post-crisis package of regulatory reforms has been the decision to dismantle the Financial Services Authority, the U.K.’s single integrated regulator for
banking, securities, and insurance, and to replace it with a “Twin Peaks” structure involving separate prudential and business conduct regulators. The Financial Services Act, which received its Royal Assent in December 2012 and came into force on April 1, 2013, created two successor agencies to the Financial Services Authority (FSA): the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).¹ The PRA is a specialist prudential regulator of all deposit-taking institutions, insurance companies, and a limited number of designated investment firms. An investment firm will be designated if it either deals in securities as principal or has minimum capital of €730,000. Firms that either do not deal as principal or which have minimum capital below the threshold are prudentially regulated by the FCA, which is also the business conduct regulator of all financial firms, irrespective of whether or not they are prudentially regulated by the PRA.

The concept of a “Twin Peaks” regulatory structure had been extensively debated during the mid-1990s in the U.K., although at the time its critics had dismissed it as far too radical, somewhat ironically in view of the subsequent adoption of the even more radical single regulator model.² In summary, the Twin Peaks concept was based on the observation that the evolution of modern financial markets had blurred the boundaries between different types of firms and financial products, rendering obsolete regulatory systems that were structured around specific types of financial firms (the “institutional” model) or types of financial products (the “functional” approach.) In place of these traditional agency structures, Twin Peaks proposed a regulatory system structured around the different objectives of regulation—broad financial system stability and consumer protection. These objectives ought to be the responsibility of different agencies—the eponymous “Twin Peaks”—since they involved fundamentally different skills and expertise, and would sometimes involve policy trade-offs that were best


clearly articulated and dealt with in the public realm rather than within the confines of an agency. This concept was subsequently influential in shaping regulatory structures in Australia and the Netherlands, but the 1997 decision to move to a single integrated regulator in the U.K. appeared to have removed the prospect that it would ever be implemented there.

The formation of the FSA was justified, at least retrospectively, using arguments similar to those deployed in favor of the Twin Peaks model, but it represented an even more radical consolidation of nine previously existing specialist regulators that were responsible for both prudential and business conduct matters. Defenders of this experiment argued that a single financial regulator was necessary to provide effective oversight of diversified financial conglomerate groups, to ensure seamless consumer protection regulation of products that were increasingly difficult to slot into traditional contractual forms, and to achieve economies of scale and scope in the utilization of regulatory resources. One of the most controversial aspects of the new institutional structure was that it combined both prudential and business conduct regulation within a single agency. The combination of functions was justified on the grounds that many relevant supervisory judgments overlapped, and that there were synergies between the two forms of regulation. Nonetheless, it was a degree of consolidation that went further than previous attempts to establish integrated financial regulatory agencies, most of which had been in the comparatively small Scandinavian financial systems.

Although some critics were skeptical about the viability of a single financial regulator for a financial sector as large and as diverse as that of the U.K., there was little genuine debate about the merits of this institutional structure before it was implemented. In contrast to the standard practice for major government decisions in the U.K., which are often preceded by a report from an independent commission and a

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4. The nine agencies comprised the Securities and Investments Board, the Personal Investment Authority, the Investment Management Regulatory Organisation, the Securities and Futures Authority, the Supervision and Surveillance Division of the Bank of England, the Building Societies Commission, the Insurance Directorate of the Department of Trade and Industry, the Friendly Societies Commission, and the Registrar of Friendly Societies.
“White Paper” setting out the government’s legislative intentions, the decision to create the FSA was announced without any prior public consultation or discussion after the government had been in office for less than a few weeks. This mode of decision-making has fueled suspicions that it was driven by the demands of the legislative timetable in which the Treasury, as the responsible ministry, was restricted to only being able to introduce one bill during the first session of the new parliament.\(^5\) The result was that plans to reform business conduct regulation separately from banking supervision had to be shelved. Instead, the legislation designed to grant the Bank of England independence in respect of monetary policy was also used to transfer its bank regulatory function to another agency, the Securities and Investments Board, thereby setting in motion the process that led to the creation of the FSA. The relevant legislation was prepared within the first weeks of the new parliament, with the transfer of powers being added relatively late in the process. One consequence of the way in which this decision was reached, the speed with which the formation of the FSA was announced, and lack of prior consultation on the decision was that the relationship between the FSA and the Bank of England did not receive detailed consideration, even though the new institutional structure involved removing banking supervision from the central bank, an issue that had not arisen in the Scandinavian models that were invoked by the FSA’s architects. Nonetheless, the upshot was that the relationship between the central bank, as lender of last resort and crisis manager, and the agency responsible for supervising individual firms, is one of the most important issues in designing a regulatory structure and was largely neglected in designing the post-1997 arrangements. A “Tripartite Agreement” between the Treasury, Bank of England, and FSA attempted to paper over the cracks, but as the crisis was to demonstrate, it was largely ineffective.

Nonetheless, these shortcomings were not exposed until the financial crisis first manifested in the U.K. with the failure of the mortgage bank, Northern Rock, in September 2007. Before then the FSA model had won many plaudits, including from the International Monetary Fund, which observed in 1998 that:

In the United Kingdom, where financial regulation has been

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spread thus far among nine separate bodies, the shift to a single regulator will clarify regulation and improve supervision of increasingly integrated multi-sector financial institutions. Unified supervision of complex financial groups will also strengthen the FSA’s ability to regulate the City’s large, internationally integrated financial market. Consumer protection, a major mandate of the FSA, should also be strengthened and become more uniform.  

In particular, the FSA’s “principles-based” approach to regulation, which attempted to put the onus for compliance with regulatory standards on a firm’s management, was widely viewed as having contributed to the relative success of the City of London as an international financial center. A 2006 study commissioned by New York Mayor Bloomberg and Senator Schumer, and conducted by the consultancy firm McKinsey, identified the U.K.’s principles-based approach as a source of competitive advantage vis-à-vis New York. The report commented that

> [b]usiness leaders increasingly perceive the UK’s single, principles-based financial sector regulator – the Financial Services Authority (FSA) – as superior to what they see as a less responsive, complex US system of multiple holding company and industry segment regulators at the federal and state levels. Regulatory enforcement style also matters, with the UK’s measured approach to enforcement seen as more results-oriented and effective than a US approach sometimes described as punitive and overly public.  

Thus, for all the radicalism of the U.K.’s institutional change and the lack of prior debate, it appeared by 2006 that the experiment had been a great success.

In 1997 the Labour government’s decision to create the FSA was met with relatively muted opposition despite it being made with


little advance preparation or prior public debate. Few critics were prepared to challenge the concept of a single regulator and they gained little traction in an environment where the government enjoyed widespread popularity and a substantial opinion poll lead over the defeated Conservative party. Importantly, the decision to create the FSA was not opposed by the Conservatives; their attention focused instead on ensuring that the new regulator did not become an unaccountable bureaucratic “Leviathan” that would be unresponsive to the financial industry.8 However, as the full extent of the government support needed by the banking sector became apparent in early 2009, there were clear signs that the Conservative opposition was beginning to rethink its earlier (and at least tacit) acceptance of the case for a single integrated regulator. A policy paper prepared for the party by Sir James Sassoon—a former investment banker and former advisor to Labour Finance Minister Alastair Darling—advocated adoption of a “Twin Peaks” structure that would involve the institutional separation of prudential from business conduct regulation.9 Importantly, the prudential “Peak” would form one of the functions of an enhanced Bank of England. A similar proposal was put forward by a senior banker, Sir Martin Jacomb, in a paper for the Conservative party aligned think tank, the Centre for Policy Studies.10

It has been argued that there was nothing fundamentally wrong with the FSA model and that it would have been possible to address the shortcomings that became apparent during the crisis without fundamental institutional reform.11 Critics have argued that the U.K. government embarked on structural reform of regulation for political

8.  See e.g., MARTIN MC EWEE & ANDREW TYRIE, CTR. FOR POLICY STUDIES, LEVIATHAN AT LARGE: THE NEW REGULATOR FOR THE FINANCIAL MARKETS 1-2 (2000) [hereinafter MC EWEE & TYRIE], available at https://andrewtyire-admin.conservativewebsites.org.uk/sites/www.andrewtyrie.com/files/leviathan_at_large.pdf (arguing “[t]he FSA will be the most powerful, and one of the least accountable, institutions created in the United Kingdom since the War. It will be, in many respects, legislator, investigator, prosecutor, judge, jury and executioner.”).


reasons rather than because there were compelling policy reasons for it to do so; in particular, it is argued that reform provided an opportunity for the government to pin the failures of regulation, which had led to substantial bail-out costs, on its predecessor. While politics no doubt played a role in the government’s decision to embark on its reforms, there were also strong policy considerations for it to do so. The relative absence of a policy debate prior to the FSA’s creation meant that the post-1997 institutional structure rested on flimsy intellectual foundations. The issue of crisis management arrangements and connection with the lender of last resort has already been mentioned; reliance on the Tripartite Memorandum of Understanding resulted in a situation in which, as a Committee of the House of Lords put it with some exasperation, “no one was in charge” of managing the crisis.12

There were also two further factors that resulted in a reassessment of the FSA model. The first was the desire to create an institutional structure in which prudential regulation at the level of the individual firm was closely integrated with a post-crisis emphasis on monitoring and controlling risks across the financial system as a whole (referred to as “micro-prudential” and “macro-prudential” regulation respectively.) Secondly, the experience of the crisis appeared to demonstrate that an agency that combined both prudential and business conduct regulation would face a constant struggle to reconcile these different objectives, and that doing so would place excessive demands on the attention of senior management. It seemed increasingly clear that one of the two objectives would be dominant at any particular time to the detriment of the agency’s ability to fulfill the other objective. If the aim of public policy was to ensure that both objectives were pursued equally vigorously, then it became increasingly apparent that an agency with responsibility for both of them was a sub-optimal solution.

With respect to the first factor, as Sir James Sassoon explained in a newspaper interview, the crisis experience had demonstrated the need to put “macro-prudential” regulation at the heart of the supervisory system and to ensure that macroeconomic policy and policies for financial stability were properly coordinated. 13 The focus on “macro-

prudential” regulation was an important post-crisis innovation in the regulatory system as policymakers concluded that a focus on the soundness of individual institutions had neglected the risks to the system as a whole. By concentrating only on what came to be referred to as “micro-prudential” regulation—i.e., the safety and soundness of individual institutions—the pre-crisis regulatory system had missed the build-up of risks across the system as a whole. Micro-prudential supervision might be described as having committed the fallacy of composition: the assumption that if firms were individually well-capitalized and financially sound, the same would be true of the system as a whole. Yet this neglected important dimensions in which the soundness of the system was not simply the sum of the soundness of individual firms. One such issue was the build-up of risks over time, for example the rapid rise in leverage across the financial system, including in sectors that were not subject to regulation (the so-called “shadow banking” sector). Another issue that cried out for a system-wide perspective was the interconnectedness of markets, for example when margin calls in one market triggered selling in another, thus leading to a downward spiral in asset prices in general. Policymakers began to explore tools for addressing both of these dimensions of systemic risk.

Among the instruments that were added to the new macro-prudential tool kit were capital requirements that varied according to the state of the economic cycle and targeted adjustments to the risk weighting applied to certain assets (for example loans to commercial property or mortgage loans). Although macro-prudential in purpose, many of these instruments applied at the level of individual institutions. Hence, the addition of a macro-prudential dimension to the supervisory system raised issues of institutional structure, in particular how best to coordinate the application of policies at both a system-wide and individual institution level. An IMF working paper that examined the range of possible institutional arrangements concluded that a “Twin Peaks” structure with a close relationship between the central bank and the prudential regulator would be the most efficient arrangement for managing the relationship between micro- and macro-prudential

Hence the Conservative party’s thinking on the future structure of regulation was aligned with an emerging trend that emphasized the importance of the macro-prudential dimension to policy being well coordinated between the prudential regulator and the central bank. To this extent, the justification for the proposed new structure was consistent with a more traditionalist conception which had emphasized that as lender of last resort (LLR) the central bank needed access to information about the financial condition of specific banks and, hence, (at least in some versions of the argument) needed also to be the prudential regulator.16

The second factor that supported the decision to dismantle the FSA was the observation that the integrated regulator had struggled to hold in balance two different regulatory objectives: (i) maintaining the safety and soundness of financial institutions; and (ii) protecting consumers against the mis-selling of financial products. The FSA had inherited responsibility for enforcing the U.K.'s extensive system of consumer protection regulation created by the Financial Services Act 1986.17 This Act had imposed a set of detailed business conduct rules for securities and investments as an overlay to the prudential regulatory regimes that had been applied to banks and insurance companies. The Self-Regulating Organizations (SROs) that had been established to apply these business conduct rules were organized along functional lines, with different bodies applying rules to securities, futures and options, asset management, and “packaged” financial products such as life insurance. As the successor agency to the SRO system, a substantial amount of the FSA’s work was devoted to consumer protection issues, in addition to its role as regulator of the safety and soundness of banks and insurance companies.

As several reports on the FSA’s regulation prior to the onset of the 2007 crisis have emphasized, the regulatory agency’s focus was on the regulation of business conduct at the expense of prudential


16. For an example of how the Bank of England’s then Deputy Governor Howard Davies understood the justification, see Howard Davies, Financial Regulation: Why, How and By Whom?, BANK OF ENG. Q. BULL. 107, 111 (1997).

17. The Financial Services Act 1986 (confusingly also referred to as “the FSA”) was repealed and replaced by the Act that established the FSA, the Financial Services and Markets Act 2000.
regulation. The FSA’s own inquiry into its supervision of Northern Rock established that although there had been frequent contact with the bank on consumer protection issues (an initiative referred to as “treating customers fairly”), supervision of capital and liquidity had been deficient and the bank had been placed in a category that subjected it to a major prudential meeting once every three years. 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.”

A Committee of the House of Lords (the upper legislative chamber in the U.K.) that examined the FSA’s failings as the supervisor of Northern Rock thought it could identify the reason why the agency had failed to give sufficient attention to prudential regulation:

Conduct-of-business is important and politically sensitive, and its results are easy to measure. In contrast, prudential supervision, while arguably more important, is conducted privately; its success is less easily measured, and, most of the time, it has a lower political impact than conduct-of-business supervision though in times of crisis such as the present its political impact, its effect on businesses, individuals and the economy, is very much greater than conduct-of-business supervision. It is natural and rational for a supervisor with responsibility for both activities to concentrate on the one with the greater immediate political sensitivity.

Consistent with this analysis, following the onset of the financial crisis the FSA’s attention shifted to prudential supervision to the exclusion of its other functions. Post-crisis the issue “with the greatest political sensitivity” was the prudential soundness of financial firms, banks especially. Thus, from having been dominated by conduct-of-business issues to the virtual exclusion of prudential supervision, the post-2007 FSA came to be dominated by prudential concerns to the detriment of its conduct of business role. The shift of emphasis became apparent in the FSA’s discharge of its non-prudential functions, including the extent to which it was active in following up on

allegations that LIBOR (the London Interbank Offered Rate) was being manipulated by traders at several leading banks. The FSA’s handling of this issue led to criticism from a parliamentary committee for being “two years behind” the U.S. regulatory agencies, and its own internal audit report concluded that

the FSA’s focus on dealing with the implications of the financial crisis for the capital and liquidity positions of individual firms, together with the fact that contributing to or administering LIBOR were not “regulated activities,” led to the FSA being too narrowly focused in its handling of LIBOR related information. This was both in terms of challenging and inquiring about that information, and considering its conduct responsibilities in relation to the Principles for Businesses and any potential for consumer or market detriment. Our view is strengthened by the fact that the FSA did go on to take enforcement action in relation to the FSA’s Principles for Businesses.

Commenting on the report, the FSA’s Chairman, Lord Turner, observed that “a particularly important lesson is the need to have staff focused on conduct issues even when the world rightly assumes that the biggest immediate concerns are prudential; and vice versa. The new ‘twin peaks’ model of regulation will deliver this.”

It would be easy to dismiss the changes to the U.K.’s institutional arrangements as mere window-dressing or, in a time-honored phrase, “re-arranging the deckchairs on the Titanic.” There is certainly a pattern of political leaders engaging in post-crisis institutional reforms, involving the closure or merger of existing agencies and the creation of new ones. On occasion these reforms


may be motivated by a genuine desire to improve the practice and
effectiveness of supervision, but in others they can be an example of
displacement activity, an attempt to being seen to “do something” in the
wake of financial crisis. As I have argued above, the U.K.’s reforms to
the structure of regulation do not fall into the latter category: they are
well-grounded in public policy considerations and represent a response
to genuine weaknesses identified during and after the financial crisis.

II. ADDRESSING “TOO BIG TO FAIL”

Less controversial than reforming the institutional structures of
regulation has been the need to address the problem of TBTF financial
institutions. This has been a common theme running through many
recent reforms in the U.S., the U.K., and in international bodies such as
the Financial Services Board (FSB). The FSB has described TBTF
firms as institutions of such size, market importance, and
interconnectedness that their distress or failure would cause significant
dislocation in the financial system and adverse economic
consequences. Without an effective legislative, regulatory, and policy
framework to resolve such firms, their threatened failure leaves public
authorities no option but to bail them out, passing costs of failure to
taxpayers. TBTF firms thus benefit from a public subsidy. This has
deleterious consequences for market discipline, incentives, systemic
risk, and public finances.

The broad thrust of public policy, in both the Dodd-Frank Act in
the U.S. and in U.K. reforms, has been significantly to reduce the
probability of failure and the impact of failure of TBTF firms by
increasing loss absorbency (i.e. capital requirements) and ensuring that
they can be resolved safely, quickly, and without destabilizing the
financial system and exposing the taxpayer to the risk of loss. The aim
has been thereby to roll back the systemic and moral hazard risks
associated with TBTF institutions and to increase market discipline.

The FSB approach to the TBTF problem rests on three pillars of: (i) higher loss absorbency in the form of more common equity tier 1


capital for banks assessed to be systemically important; (ii) more
intensive and effective supervision of these firms, including holding
them to higher standards in terms of systems and controls and data
aggregation than other firms; and (iii) effective resolution regimes and
resolution planning, including powers and tools to enable creditor-
financed recapitalization, mandatory recovery and resolution planning
for G-SIFIs, negotiation of institution-specific crisis cooperation
agreements within cross-border crisis management groups (CMGs), and
regular resolvability assessments.24

The U.K. authorities have been closely involved in the
development of this approach and have been working directly with their
counterparts in the U.S. to develop effective cross-border resolution
strategies.25 An important post-crisis legislative initiative in the U.K.
was the enactment of the Banking Act 2009, which establishes a Special
Resolution Regime for banks comparable (at least in certain respects) to
the powers long enjoyed by the FDIC.26 The Act, which was a direct
product of the limited options that existed for resolving Northern Rock,
provides the Bank of England, as the resolution authority, with a broad
tool kit for bank resolutions including the power to:

- transfer all or part of a bank’s business (its
  shares or property, i.e. assets and liabilities) to a
  private sector purchaser;
- transfer all or part of a bank’s property to a
  bridge bank—a subsidiary of the Bank of
  England—pending a future sale;
- place a bank into temporary public ownership (a
  decision made by the Treasury);
- apply to put a bank into the Bank Insolvency
  Procedure (BIP) which is designed to allow for
  rapid payments by the Financial Services

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24. Id.
25. On December 10, 2012, the FDIC and Bank of England published a joint paper on
resolving internationally active systemically important financial institutions. See FED.
DEPOSIT INS. CORP. & BANK OF ENG., RESOLVING GLOBALLY ACTIVE, SYSTEMICALLY
IMPORTANT, FINANCIAL INSTITUTIONS (2012), available at
x (last visited Sep. 12, 2013).
Compensation Scheme (FSCS) to insured depositors (or transfer of their accounts to a healthy bank);

- apply for the use of the Bank Administration Procedure (BAP) to deal with a part of a bank that is not transferred and is instead put into administration.

Although the U.K.’s reform of its framework for bank resolution represents a significant step beyond the pre-2009 arrangements, which effectively required failed banks to be dealt with under general insolvency law, it is still some way short of fully implementing the recommendations of the FSB’s Key Attributes for Effective Resolution Regimes. In a review conducted in early 2013, the FSB found that the U.K. authorities still lack the power to convert debt into equity as part of a bank recapitalization and also lack the power to impose a temporary stay on the early termination of rights in financial contracts. Both gaps in the Bank of England’s powers will be addressed once the European Union’s Recovery and Resolution Directive (RRD) is finalized and implemented.

The FSB’s Key Attributes are a major component in its strategy for resolving systemically important financial institutions described above. However, doubts nonetheless remain about how effective this approach to ending TBTF will be in practice. As several commentators have pointed out, the application of a resolution regime to a systemically important firm is untried and untested; it relies on the willingness of resolution authorities in different jurisdictions to cooperate closely when the incentives are to protect domestic creditors.


29. See e.g., Edward F. Green, Dodd-Frank and the Future of Financial Regulation, 2 HARV. BUS. L. REV. ONLINE 79, 88 (2011), available at http://www.hblr.org/?p=1728 (“Absent further coordination in cross-border insolvencies of systemically important financial institutions, we are left with the dilemma of an uneven treatment of creditors and shareholders and a tendency for the regulators of markets in which large institutions operate to require operations to be conducted through subsidiaries, to ring-fence assets in those domestic subsidiaries, to impose liquidity requirements to protect domestic creditors and to avoid the transfer of assets prior to insolvency.”).
(depositors especially); it is only really suited to dealing with idiosyncratic problems at an individual firm, rather than with system-wide risks. Perhaps in response to these concerns, some countries have adopted structural regulation measures in addition to taking steps to implement the FSB’s proposals and recommendations. These structural measures are best seen as an attempt to confine the safety net to a subset of banking activities—payments and intermediation—by separating them from investment banking and capital market activities. Proposals for structural reform also aim to improve financial stability by (i) reducing the risk of cross contamination between investment and commercial banking, achieved by separating the capital allocated to the two activities and disallowing blended funding, (ii) acting on the “risk culture” of firms by reducing the extent to which the incentives and risk-appetite of transactions-based trading activities are spread to relationship-based commercial banking activities, and (iii) increasing the loss absorbency capacity in the banking system and improving the resolvability of firms.

Three broad models for structural reforms have emerged: one places an outright prohibition on certain combinations of financial activity (the Volcker Rule contained in section 619 of the Dodd-Frank Act). The alternative approaches, associated with both the U.K.’s Independent Commission on Banking (the ICB or “Vickers Commission”) and the High-Level Expert Group on reforming the structure of the EU banking sector chaired by Bank of Finland Governor Erkki Liikanen emphasizes instead the requirement for different types of financial activity to be conducted by separately capitalized subsidiaries within a common holding company structure.\(^3\) The fundamental differences between these approaches are summarized in the table\(^3\) below:


\(^{31}\) *Id.*
Under the ICB approach, each banking group headquartered in the U.K. will be required to “ring-fence” critical banking services whose temporary interruption would have a significant direct impact on the domestic economy, in particular on households and small and medium-sized enterprises (SMEs). The aim of this policy is to:

- insulate critical banking services from shocks elsewhere in the financial system; and
- make it easier to preserve the continuity of those services, while resolving financial institutions in an orderly manner and without injecting taxpayer funds.

Within its own group the ring-fenced bank will need to be a separate legal entity with at least half of the board of directors that is independent of the rest of the group. It should be able to meet capital and liquidity requirements on a stand-alone basis. Higher capital requirements will be applied to ring-fenced entities.

“Ring fencing” has two dimensions, referred to in the ICB report as “location” and “height.” The former refers to the designation of which services should be in and which should be outside the ring-fenced entity. The latter refers to the permitted relationship between the ring-fenced entity and other financial institutions, both inside and outside the same group.

With respect to the location of the ring fence, the U.K.
government plans to mandate that certain financial services should only be provided by a ring-fenced entity: these are primarily taking retail deposits and the provision of overdrafts to individuals and small and medium-sized enterprises. Ring-fenced entities will be permitted to provide certain other types of financial products and services, such as consumer and SME loans, mortgages, credit cards, corporate lending, leasing and factoring, and wealth management advisory services and ancillary operations necessary to support permitted services (such as the hedging of credit, market and liquidity risk). However, it will not be mandatory for these activities to be included within the ring fence and there will be costs to their inclusion owing to the higher capital requirements, which the ring-fenced entity will be required to meet.

Certain other services will be excluded from ring-fenced banks, particularly those which impede resolution and/or increase a ring-fenced bank’s exposure to shocks from financial markets. Activities which ring-fenced banks will be prohibited from conducting include any services provided outside the European Economic Area\(^3\) and the following:

- origination, trading, lending or making markets in securities (including structured investment products) or derivatives;
- secondary market purchases of loans and other financial instruments;
- conduit financing or securitization of assets originated outside the ring-fenced bank; and
- underwriting of securities issues.

With respect to the “height” of the ring fence, the U.K. government proposes that ring-fenced banks should be prohibited from entering into any transaction with a financial institution that results in an economic exposure to that institution, other than for the purposes of:

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32. The U.K.’s obligations under the European Union Treaties prohibit it from discriminating between financial services that are provided domestically and those that are provided in other EU Member States or members of the European Economic Area. In consequence, it was not possible for the U.K. to follow the strict logic of the ring-fencing approach, which would have been to restrict the ring-fenced entity to purely domestic operations.
facilitating payments for other financial institutions (ring-fenced banks should be permitted to settle payments for financial institutions; this will naturally result in exposures, so these activities should be monitored closely so that they do not undermine the aim of the restriction); 

- the management of liquidity (where ring-fenced banks may place deposits with other financial institutions and hold claims as part of their liquidity resources, as approved by the regulator); and

- acting as derivatives counterparties for the purposes of ring-fenced banks' risk management (subject to certain safeguards).

Ring-fenced banks will be prohibited from dealing with counterparties which (i) engage in financial intermediation, and (ii) those which may be highly leveraged, have a high degree of maturity or liquidity mismatch, or have a high degree of financial interconnectedness. The Prudential Regulatory Authority will be empowered to issue rules that will restrict their dealings with other types of financial institution including: (i) non-ring-fenced banks, or banks that engage in otherwise prohibited activities; (ii) investment firms; (iii) funds and fund management companies; and (iv) insurance companies. The regulator will also impose limits on large exposures, intra-group transactions, and intra-group funding (for example limits on the proportion of the ring fenced banks funding that is derived from the rest of the group.)

The ICB proposed ring-fencing of U.K. banks' retail operations without going as far as to require full institutional separation of commercial from investment banking, as it recognized that there were financial stability benefits arising from the diversification of business lines and activities; it argued that a diversified financial group would be better placed to absorb shocks arising from either the capital markets or the real economy than would stand-alone entities. For this reason, the ICB decided not to recommend the complete separation of trading activities from commercial banking, but instead to require domestic
deposit-taking activities to be placed inside a ring-fenced entity which could, nonetheless, be part of a diversified financial group, and recommended a higher level of capital for ring-fenced activities. The ICB also concluded that there were difficulties in drawing the Volcker Rule's distinction between proprietary trading and hedging activities and therefore proposed a narrow definition of the range of activities that would be permitted within the ring-fence, principally domestic deposit taking and lending to households and SMEs. The extent to which certain simple hedging instruments (e.g. interest rate swaps) may be permitted within the ring-fence has emerged as one of the main issues in designing proposals to implement the ICB's recommendations.

The U.K. government introduced the Banking Reform Bill into parliament on February 4, 2013 to implement many of the recommendations of the Independent Commission on Banking; it is expected to complete its passage through parliament and come into force in early 2014. The reforms will be in place by 2019. In the draft legislation the ring-fencing proposals have been largely retained intact, although differences have emerged between the government and a special committee of both Houses of Parliament, the Parliamentary Commission on Banking (PCB), on the extent to which the ring-fence should be "electrified." The PCB has recommended that attempts by individual banks to circumvent the ring-fence should result in supervisory action to break-up the group and that there should be a formal review at a specified future date of the effectiveness of the ring-fencing arrangements, with a view to adopting full separation of investment and commercial banking. At the time of writing, the government has accepted the first of these recommendations but not the second. A further point of contention between the government and the parliamentary commission concerns the "leverage ratio" which should be applied to U.K. banks. The government favors applying the three percent ratio which forms part of the internationally agreed Basel III framework, while the PCB favors a more restrictive four percent ratio. One factor in the government's reluctance to raise the leverage ratio above the international minimum could be that two large U.K. banks, both of which have substantial government ownership as the result of bailouts during the crisis, would be unable to reach the higher ratio without either fresh capital raising or reducing the volume of their assets at a time when the domestic supply of credit has become a politically
contentious issue.

III. ASSESSMENT OF THE U.K. REFORMS

Both major elements of the U.K.'s post-crisis regulatory reforms reflect the importance of political economy factors in the design of regulation. The reform to the institutional structure of regulation was shaped by the perception that the single regulator model had "failed" both in its ability to provide effective supervision of the banking sector pre-crisis and in providing a basis for an effective crisis management arrangement once problems in the sector began to emerge. However, the reforms were undoubtedly underpinned by more overtly political factors—in particular the close identification of the single regulator with the previous government and the fact that, in contrast to most major institutional reforms in the U.K., it was not the product of a prior consultation exercise aimed at building a broad consensus.

Although a consensus in favor of a single regulator did emerge once the decision to create it had already been made, in reality it rested on flimsy foundations, the result of a fait accompli rather than a compelling case for a fully integrated regulatory agency. The reforms also commanded widespread support from the financial sector, which welcomed a single regulatory agency as reducing duplication and overlap in rules and their enforcement, thereby resulting in lower direct compliance costs. Maintaining the competitive position of the City of London vis-à-vis rival financial centers was an explicit objective of the 1997 reforms, to the extent that competitiveness considerations were written into the FSA's statutory objectives. The extent to which this strategy was initially successful is indicated by the report commissioned by Mayor and Senator Schumer referenced earlier. However, in a post-crisis environment it no longer appeared politically desirable to place such heavy emphasis on using regulation to support the City's competitiveness or in meeting industry demands for "light touch" regulation. Instead, the primary goal of public policy became that of protecting taxpayers against the contingent liability that arises from playing host to a large financial center. This provided the background against which the new Coalition government was able to enact its proposals with relatively little opposition or resistance from the

33. See McELWEE & TYRIE, supra note 8.
industry. Arguments deployed by the financial sector against the reforms that were based on alleged transition costs or the higher ongoing operating costs of the new system could gain very little traction with law-makers given the evident failings of the previous system and the fact that industry concerns carried very little weight in a post-crisis environment.

The U.K. approach of de-merging a highly integrated regulatory agency reflects a very different institutional starting point to the U.S., where the emphasis over the years has been on bringing about greater integration of regulatory agencies. A 2008 Treasury Department proposal for institutional reform, often referred to as the “Paulson Plan,” also built on a “Twin Peaks” approach to regulatory structure.\(^\text{34}\) The Treasury proposal envisaged a new Prudential Financial Regulatory Authority (PFRA) that would be responsible for the safety and soundness of individual firms with some type of explicit government guarantee of their business operations (e.g. banks and insurance companies) while a consolidated business conduct regulator (a Conduct of Business Regulatory Agency or CBRA) would be responsible for monitoring the business conduct of all financial firms. The underlying logic of these proposals was obviously very close to the objectives-based concept that underpinned the Twin Peaks approach that the U.K. eventually adopted. Nonetheless, although the CBRA survived in the attenuated form of the Consumer Finance Protection Bureau (without the addition of the consumer protection role of the SEC and CFTC as originally envisaged) few of the other ideas embodied in the Paulson Plan survived into the Dodd-Frank Act. The reasons are complex and the episode deserves to be researched in more detail than has so far been the case. Nonetheless, a change of administration, the lobbying of industry groups that had established close links with existing regulatory agencies, and reluctance of Congressional committees to abandon their oversight role of specific agencies all arguably played a part.

There has been a strong political consensus in the U.K. in favor of addressing TBTF financial institutions, especially as the economic and fiscal costs of support to the banking sector in early 2009 have become apparent. Britain faces the TBTF problem in a particularly

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acute form—banks that are large relative to the size of the economy and which represent a significant contingent liability for the government in the event that they have to be bailed out (sometimes referred to as the "too big to save" problem). Despite post-crisis deleveraging, the British banking system is still around 450 percent of U.K. national output. Several countries with large banking systems have found that the costs of providing capital support to the sector have called into question the solvency of the sovereign itself (Iceland, Ireland and Cyprus among others). Although the U.K. banking system is not as large relative to the economy as in these countries, the contingent liability that results from hosting large, globally active banks is now recognized by politicians from all political parties to represent a major risk to the sovereign and taxpayers.

At the same time, however, the general view among British policymakers is that playing host to large, globally-active banks generates significant economic benefits to the U.K. in terms of direct and indirect employment, corporation and personal taxation, and securing London’s position as an international financial center. Almost all British politicians regard the City of London as a vital economic asset which they therefore will take the necessary policy measures to defend. This political commitment has meant that threats (even if only implicit) by the senior management of some large U.K. banks to consider relocating to "friendlier" jurisdictions carry real force, even if only the most cursory analysis would suggest that such threats are largely hollow, since they assume that any possible alternative location for the mind and management of these firms would be any more comfortable with the resulting contingent liability on the public finances than is currently the case in the U.K. The ring-fencing approach outlined by the Independent Commission on Banking was the outcome of these competing political pressures, and to this extent represents something of a political balancing act.

The ring-fencing proposals are intended to address the TBTF problem by tightly circumscribing U.K. banks’ domestic financial functions, thus ensuring that any future support can be targeted to protect local depositors and to ensure the flow of credit to British businesses. Although EU law prohibits the ring-fence from being applied on a national basis—the relevant geographical scope is the European Economic Area—the intention behind the legislation is
clearly to limit the U.K. government’s contingent liability to only a subset of the activities of globally active banks. The aim has been to limit the U.K. government’s contingent liability while avoiding the imposition of conditions on U.K.-based banks that are so harsh that they might relocate elsewhere. In consequence, the U.K. has been taken in a radically different direction to the U.S., following the incorporation of the “Volcker Rule” in the Dodd-Frank Act. The ICB itself concluded that there were economic benefits from the diversified, “universal” banking model, including the stability of earnings over time, that should be preserved. Rather than recommending a strict separation of commercial and investment banking, the ICB instead sought to preserve the model but in a way that ensures that large universal banks will become easier to resolve and that the U.K.’s contingent liability to support globally-active financial institutions will be limited as a result.

Two other factors influenced the U.K.’s decision not to follow the Volcker Rule’s imposition of a bright line separation of banking from capital markets trading activities. The first is that historically the U.K. has never had structural regulation to separate banking from securities business (along the lines of Glass-Steagall in the U.S.), despite the fact that until the mid-1980s such a separation was observed in practice. The separation was the result of private ordering, particularly Stock Exchange rules that required member firms be established as partnerships, rather than statutory requirements. Thus there has been no precedent for British legislators imposing specific business models on financial institutions. The second is that the debate in the U.K. was able to draw on the experience of the U.S. in implementing the Volcker Rule. The difficulties of developing a workable definition of “trading” activities, which could be clearly differentiated from market making, has become apparent during the U.S. regulators’ implementation efforts. Even legislators who are sympathetic to the case for separating banking and trading activities have recognized this problem.\footnote{See e.g., PARLIAMENTARY COMM. ON BANKING STANDARDS, PROPRIETARY TRADING, 2013, H.C. 1034 (U.K.).}
In conclusion, the differences between U.K. and U.S. approaches to post-crisis financial reforms reflect the same factors that were highlighted in my paper with Heidi Schooner that took in a much longer historical sweep of contrasts and comparisons of the two countries’ approach to bank regulation. These factors include differences in assumptions about the role and purposes of regulation, institutional structures, legal systems and, in particular, the political economy of financial regulation. In the reform process that has followed the financial crisis, the U.K.’s focus has been on handing powers back to a central bank that had been removed of its responsibilities for banking supervision and on reducing the risks to British taxpayers that arise from hosting large, globally active financial institutions that are much larger in relation to the size of the British economy than even the largest U.S. institutions are in relation to theirs. Both of these aspects of the U.K.’s reform agenda have no parallels in the U.S., despite underlying similarities of analysis and approach that have found expression in the international reform agenda.