

Financial Services and Markets Act: The Policy Background – II

by Michael Taylor

In the second part of his article, taken from a book he has co-written on the Act, Michael Taylor considers the regulatory reforms introduced by the new legislation.

THE CONFLUENCE OF THE THREE STREAMS

Under the impact of these various factors (as explained in Part I – see Issue 30), the three streams of finance, which had been kept separate by custom, practice, and cartels operated by the leading institutions, had begun to converge by the mid-1990s. From being largely distinct sectors, the banks, building societies, unit and investment trusts, and insurance companies had become competitors, both as repositories of the savings of individuals and as providers of finance. The largest UK commercial banks acquired investment banking arms, while linkages between banks and insurance companies began to form. Financial conglomerates, straddling the banking, securities and insurance sectors, thus began to emerge. Parallel to these developments were the emergence of new types of financial product which did not fit readily into traditional regulatory distinctions; for example, futures contracts on the stock indices made it possible for insiders to deal or manipulate markets without acquiring any of the underlying securities.

One consequence of these developments was that the pace of structural change in the industry rapidly began to outpace the regulatory structure that had been put in place during the 1980s. For example, financial conglomerate groups found themselves subject to a plethora of different regulatory bodies, which both increased their regulatory burden and impeded the ability of any one regulator to obtain an overview of their risk profile. One illustration of this problem was the collapse of Barings in 1995, an old-established merchant bank that was brought down by problems in its securities arm. But there were other, less spectacular instances of the strains on the regulatory system beginning to show. As a result, a regulatory system

built on assumptions about clear dividing lines between different types of financial institution and product was increasingly poorly adapted to the realities of the financial marketplace as it had evolved by the end of the twentieth century. Hence a reconfiguration of regulatory structure, the better to reflect these new economic realities, was becoming a matter of necessity.

UK DEBATE

The debate in the UK that followed the publication of Michael Taylor's report for the Centre for the Study of Financial Innovation, *Twins Peaks: A Regulatory Structure for the New Century*, considered some of these issues, although it did not do so in the depth of the Commission of Inquiry appointed by the Australian government which reported in March 1997 and which drew broadly similar conclusions. (Financial System Inquiry: Final Report, Canberra, 1997). However, there was little sign that this debate had much influenced official thinking until the Chancellor's statement to the House of Commons on 20 May 1997. In consequence the latter was as unexpected as it was radical.

Announcing the decision to create what has subsequently become the Financial Services Authority, the Chancellor said:

'[I]t is clear that the distinctions between different types of financial institution – banks, securities firms and insurance companies – are becoming increasingly blurred. Many of today's financial institutions are regulated by a plethora of different supervisors. This increases the cost and reduces the effectiveness of supervision.'

In making the 'blurring the boundaries' argument the centrepiece of his justification for the government's new initiative, the Chancellor thus appeared to accept the

arguments of those who had claimed there was a need for a radical overhaul of the financial regulatory system to reflect the new economic realities of the industry. The formation of the Financial Services Authority (FSA), and the associated statutory changes in the Financial Services and Markets Act (the Act), represented the government's response to these developments. The formation of a single regulatory authority, with oversight of the entire financial services sector, eliminated problems of regulatory jurisdiction in an environment in which the old, institutionally-based regulatory structure had become increasingly outmoded. The enactment of a single statute, the Act, reflected the reality that the existence of separate banking, securities, and insurance legislation to regulate fast integrating financial services sectors was becoming increasingly redundant, and possibly an obstacle to further beneficial change.

OTHER INFLUENCES ON THE LEGISLATION

Although this blurring of boundaries argument was undoubtedly influential, other factors were equally, if not more, important in giving the Act its final shape. At least as important as the desire to bring the regulatory structure up to date were three other considerations: the decision to award the Bank of England greater independence in the formulation of monetary policy; the government's desire to end what it described as 'City self-regulation' and especially to respond to what it regarded as the scandal of the mis-selling of personal pensions; and the long standing desire on the part of the regulators, strongly supported by the new government, to obtain greater powers to combat financial crime. These different factors combined to give the Act a very different character to the one it would have had, had it merely been an attempt to introduce a modernised regulatory system.

CENTRAL BANK INDEPENDENCE

Like the decision to create a single 'super-regulator', the decision to grant the Bank of England autonomy in monetary policy did not feature in the Labour party's election manifesto. On the other hand, the intellectual ground for this surprise move had been laid well in advance by a number of influential supporters of the case for central bank independence, including several former Conservative Chancellors of the Exchequer. Nevertheless, one issue that had received comparatively little prior attention was whether the Bank of England, as an independent central bank, should also conduct banking supervision. The evidence of other countries provided two different possible models.

The first, Federal Reserve, model stresses the synergies between the conduct of monetary policy and banking supervision. In particular, since banks are the conduits through which changes in short-term interest rates are

transmitted to the wider economy, the central bank needs to be concerned about their financial soundness as a precondition for an effective monetary policy. A subsidiary argument stresses the synergies which exist between the information needed for monetary policy purposes and that needed to assess the soundness of the banking system. The alternative, Bundesbank, model stresses instead the risks to the central bank of it directly conducting banking supervision. First, a central bank which is also responsible for supervision may err on the side of laxity if it fears that tight monetary conditions may lead to bank failures. Secondly, bank failures inevitably will occur and when they do they will be blamed on the supervisor. If the supervisor is the central bank its credibility will be undermined, and with it its credibility in the conduct of monetary policy. Thus the Bundesbank model stresses that the relationship between the central bank and the banking supervisor should be sufficiently distant to limit the scope for such 'reputational contagion.'

The arguments for combination or separation of function were therefore finely balanced, and in practice the different arrangements are found in approximately equal measure in countries with independent central banks. However, in the British case two factors seem to have been decisive. First, as we have seen, the Labour party had a long history of being unimpressed by the Bank's capability as a bank regulator. This dated back to the debates on the first *Banking Act*, but was subsequently reinforced by episodes like BCCI and Barings, although neither episode resulted in a firm policy commitment to remove banking supervision from the Bank. Secondly, the *Bank of England Act 1998* presented an opportunity to effect a transfer of powers under the *Banking Act* from the Bank to the Securities and Investments Board. (See Michael Blair et al, *Blackstone's Guide to the Bank of England Act 1998*.) Hence the Act permitted the government to change the regulatory arrangements in a way which supported its general objective of modernising the system, but without the immediate need to establish a new regulatory agency. Given the circumstances of a crowded legislative timetable, such an opportunity must have seemed very attractive to the Treasury ministers. Thus, shortly after the Bank was granted monetary policy independence, the government announced that it would also lose responsibility for banking supervision to what subsequently became the Financial Services Authority.

AN END TO 'SELF-REGULATION'

As we have seen, 'self-regulation' in its truest sense had ceased to exist in the City a decade and a half before the Act. Nonetheless, Labour party spokesmen criticised the decision in 1986 not to create a statutory securities commission in the UK, and continued to insist that, in the absence of such a body, the resulting system remained largely 'self-regulatory'. Bryan Gould, the party's then

spokesman on City affairs, said in a parliamentary debate on the FS Bill that 'failure to put in place a proper independent statutory commission will be regretted by the government and is already being regretted by the City', and he also criticised the Conservative government for its failure to bring Lloyd's within the framework provided for by the Bill. The characterisation of the arrangements brought in by the Act as 'self-regulatory' provided ammunition for opposition spokesmen as evidence emerged of various regulatory failings by the new agencies it had established, and the emerging scandals at Lloyd's cast doubt on the wisdom of exempting the insurance market from the Act's scope.

THREE CONSIDERATIONS

At least as important as the desire to bring the regulatory structure up to date were three other considerations: the decision to award the Bank of England greater independence in the formulation of monetary policy; the government's desire to end what it described as 'City self-regulation' and especially to respond to what it regarded as the scandal of the mis-selling of personal pensions; and the long standing desire on the part of the regulators, strongly supported by the new government, to obtain greater powers to combat financial crime.

PENSIONS SCANDAL

Of the various scandals that afflicted the Act regulators, none had a greater impact than the pensions mis-selling scandal. The mis-selling issue concerned the way in which personal, portable pensions, introduced by the Conservative government in the mid-1980s, were marketed and sold. These pensions were provided through the life insurance companies, and were intended to be an alternative to occupational pensions which, it was argued, lead to rigidities in the labour market by encouraging workers to remain with the same employer for long periods of time. The protection of individuals against the sale of unsuitable pension plan products was to have been provided by regulatory framework established by the Act which was completing its parliamentary passage at the same time as the legislation for the new portable pensions. In the words of John Major, then a junior Treasury minister, the Act would 'safeguard people against the unscrupulous overselling of personal pensions.'

Approximately eight million personal pensions were sold in the UK between 1988 and 1995. Some were sold to people who were in occupational schemes and who were advised to transfer out of these schemes and to take out personal pensions in their place. For those prospective pensioners who were in well-funded schemes and where the prospective pension was protected against inflation, as was the case with many public sector employees, it would

be very difficult to argue that it was good advice to leave those schemes in favour of personal pensions with no employer contribution and an uncertain return. In at least some cases this mis-selling seems to have been due to the fact that insurance company salesforces were poorly controlled and were remunerated on a commission-only basis, thus leading to high pressure sales tactics. These sales practices continued notwithstanding a regulatory regime that included as its key concepts best advice and suitability, both of which had been introduced into the regulatory framework as a way of regulating the sale of complex, packaged financial products like pensions.

Nonetheless, the extent of pensions mis-selling still remains a matter of dispute, and depends on a number of assumptions, for example about the investment return and the buyer's perceived financial needs at the time. Estimates of mis-selling have varied widely. When the issue first came to public prominence in 1993, a report commissioned by the Securities and Investment Board (SIB) suggested as many as 1.5 million pensions had been mis-sold with compensation costs amounting to some £4 billion. Subsequently, these figures have been disputed by both the industry and some independent commentators, but the results of the subsequent regulatory review of the mis-selling cases suggests total compensation costs may be at least double the original estimate. There can be little doubt that, whatever the true scale of the problem, it did cause a significant loss of public confidence in personal pensions and in the system set up to regulate them.

The essence of the government's response to the mis-selling episode was to attribute it to the failings of self-regulation. The reason that mis-selling had not been detected and dealt with by regulators at a sufficiently early stage, it was argued, was because the self-regulatory organisations (SROs) failed to take adequate enforcement action. This was due to the fact that they were hamstrung by their industry-dominated boards. Meanwhile, the SIB lacked sufficient enforcement powers to ensure that appropriate regulatory actions were taken. The SIB possessed only the power to recognise a SRO, an option that was too draconian to be an effective basis for intervention. In the absence of the kinds of intervention powers available to the Securities and Exchange Commission (SEC) in its dealings with its SROs, the SIB was thus constrained from ensuring that the SROs regulated in the public interest.

While this analysis can be disputed in a variety of ways, it formed the basis for the Labour party's conclusion, while in opposition, that the complex two tier system of the SIB and SROs needed to be replaced by a single, statutory body responsible for the regulation of all securities and investments business. Although the model most often cited was that of the US SEC, this overlooked that the latter body itself made substantial use of SROs. Instead, a completely unitary system was proposed in

which the functions of the existing SROs would be absorbed into a reformed and enhanced SIB, reconstituted as a proper statutory body. This proposal formed the nucleus for what has subsequently become the FSA, although the latter has gained the important additions of banking, building society, and insurance regulation. Moreover, the FSA, like the SIB, remains a private company discharging a public function, and hence the proposal for a 'statutory commission' has never in actual fact been enacted.

DEALING WITH FINANCIAL CRIME

The third influential factor behind the new regime introduced by the Act derives from a long-standing sense on the part of the financial services regulators that they lacked adequate powers to combat financial crime, especially market manipulation and insider dealing. For several years prior to Act in speeches made by its then chairman, Sir Andrew Large, the SIB argued that there were serious shortcomings in the investigation and disposal of cases of insider dealing and market abuse. In part these shortcomings were due to fragmented jurisdictions, with the SIB having no powers over market abuse resulting from the conduct of individuals who were not authorised persons under the Act. In part they were also due to the fact that such cases could only be prosecuted under the criminal law, with a criminal rather than a civil burden of proof. As Sir Andrew remarked:


PERSONAL PENSIONS

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'[U]nder the criminal system the evidential and public interest hurdles to be cleared before commencing a successful prosecution in the criminal courts are, quite correctly, high. But, as a result, activities which take place outside the scope of the regulators, whether the actions of company directors or end users of markets, may finish up not being taken to court. And since there is no sufficient civil alternative, what we would deem unacceptable actions from a regulatory viewpoint, and which we could often deal with if entered into by someone who was subject to regulation, can currently go unchallenged.' ('Standards of market integrity in the new world', speech delivered on 29 October 1996)

In often complex cases with evidence that could only be interpreted on the basis of specialist knowledge, this meant that the number of prosecutions brought for market abuse was very small and convictions even less. The regulators spent several years pressing for a revision to the law that would permit them to dispose of cases of market abuse through civil rather than criminal channels. Significantly, this was one aspect of UK regulatory reform where its proponents seem to have drawn direct inspiration from US law and practice. This is the basis for the new Code of Market Conduct and the provisions of the Act relating to the FSA's powers in relation to individuals who breach that code.

This aspect of the Act has also proved to be the most controversial. It resulted in the draft Bill being criticised in an opinion of Lord Lester QC, commissioned by a Joint Committee of the Lords and Commons that had been established to scrutinise it, on the grounds that the proposed new regime was incompatible with the European Convention on Human Rights. It has resulted in the government introducing a number of important amendments, most notably to the proceedings of the proposed new Financial Services Tribunal which will now hear cases involving a breach of the Code of Market Conduct at first instance. Moreover, the regime has now lost its 'civil' tag, which counsel's opinion had strongly argued was something of a misnomer.

In conclusion, the Act is an attempt to modernise the UK's regulatory system by reflecting the realities of the new financial landscape that has emerged over the last decade and a half. But it is also much more than this. In abolishing the SROs its aim is to remove some of the last vestiges of the old self-regulatory practices of the City. In introducing a new regime for market abuse it aims also to ensure that the incidence of financial crime is reduced. It also reflects a changing role for the Bank of England, which has to a large extent lost its role as the City's 'head prefect'. The transfer of banking supervision to the FSA was simply the most striking example of how the old informal norms that once ruled the City, with the Bank as their accepted enforcer, have given way over the years to a regime based more explicitly on statute law and on detailed rules and regulations. The Act has been possible because the balance between statutory and self-regulation had long ago shifted decisively in favour of the latter. 

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