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# Labour's Record on Financial Regulation

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In 1997 the new Labour government launched major initiatives in the area of financial regulation, setting up the Financial Services Authority as a comprehensive regulatory body, supported by the legislative framework of the Financial Services and Markets Act 2000. We evaluate the Labour government's record on financial regulation in terms of its achievements and failures, especially in dealing with the global financial crisis that started in 2007. While we identify some clear flaws in regulatory design and enforcement, our evaluation highlights some inherent difficulties of financial regulation.

*Keywords:* financial regulation; New Labour, financial crisis.

*JEL classification:* G01, G2

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## I. INTRODUCTION

The formation of the New Labour government in 1997 was marked by bold initiatives in the area of financial regulation. Even as the government handed over operational independence for monetary policy to the Bank of England, it announced the transfer of banking supervision to a new body, to be called the Financial Services Authority. This new body was to serve as a unified statutory regulator for the entire financial sector, replacing the existing patchwork of multiple, sector-specific, self-regulatory bodies. This institutional re-design of financial regulation was matched by a new legislative framework, which came in the form of the Financial Services and Markets Act 2000.

Over the first two terms of the Labour government (1997-2001 and 2001-2005) the new regulatory structure was widely regarded as successful. The macroeconomic environment proved to be favourable, with steady growth and stable prices, a part of a trend that came to be known as the 'great moderation'. The City of London reinforced its reputation as a global hub for financial innovation, with financial services making a sizeable contribution to the UK economy. There were some signs of developing misalignments of asset prices – especially a house-price boom fuelled in part by easier access to mortgage lending – but there were relatively few financial failures or scandals.

The new regulatory structure was severely tested by the global financial crisis that occurred during Labour's third term (2005-10). Losses on 'sub-prime' mortgage loans in the US triggered a global constriction of liquidity, straining the balance-sheet of many UK financial institutions. The first and most visible major event, in 2007, was the collapse, and subsequent nationalisation, of Northern Rock, after what was widely reported as the first bank run in the UK in over 150 years.<sup>1</sup> A series of other impending failures led, in 2008 and 2009, to the much more expensive recapitalisation of the Lloyds and Royal Bank of Scotland groups, together with loan guarantee schemes to the banking system with a face value that peaked at over £1 trillion.

The financial crisis led, inevitably, to a re-assessment of the regulatory structure created by the Labour government, and calls for re-design of the institutional arrangements. Most notably, the Financial Services Authority is to be replaced in 2013 by two separate bodies: the Prudential Regulatory Authority will return banking supervision to the Bank of England, while a distinct and independent Financial Conduct Authority will regulate the rest of the industry. In addition a Financial Policy Committee has been created within the Bank of England to monitor and reduce systemic risk.

This paper assesses Labour's record on financial regulation. We begin in Section II by setting out the theoretical rationale for financial regulation. Financial

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<sup>1</sup> In fact there was a major bank run in the UK as recently as 1910 and, as we note below, the events of this less-well-known bank run provide a complex link between our own institution, Birkbeck College, and the recent failure of RBS.

markets display many of the classic market failures – for instance, information asymmetries and externalities – that make a potential case for regulatory intervention. This regulatory imperative is especially strong if the failure of institutions can have significant effects on individuals and if systemic financial crises can damage the real economy. We identify the case for specific forms of financial regulation, and also discuss the ‘boundary problem’ – how far can regulation extend?

Section III presents a brief history of financial regulation in the UK before 1997. Unlike the US which introduced an extensive system of statutory regulation in the aftermath of the Great Depression, the UK’s financial services industry evolved a largely self-regulatory system. The Bank of England, after its nationalisation in 1946, exercised its power in mostly informal ways, achieving formal supervisory powers over deposit-taking banks only as late as 1979. A broad pattern of structural liberalisation allowed new entrants in previously-protected sectors, interspersed with bouts of new regulations, mostly in reaction to instances of financial crises and scandals. This reactive tendency foreshadows similar patterns under Labour, and indeed thereafter.

Section IV spells out the regulatory reforms carried out by the Labour government after 1997, notably the creation of the Financial Services Authority (FSA) and the enactment of the Financial Services and Markets Act (FSMA) 2000. Among other things, we discuss the creation of a tripartite structure of financial regulation, involving the FSA, the Bank of England and the Treasury. Section V examines how this structure coped with the financial crisis, focusing on two illustrative events – the run on Northern Rock in 2007 and the recapitalisation of the Royal Bank of Scotland group in 2008.

Section VI offers an evaluation of the regulatory structure at two levels. Labour’s regulatory design was clearly a product of its times, drawing from then prevalent conventional wisdom that extolled the gains from financial innovation and expressed confidence in the ability of financial markets to regulate themselves. We assess the extent to which the UK regulatory design fell short relative to what would have been reasonable even given this conventional wisdom. At a different level, we marshal the advantages of hindsight, to ask: did Labour’s creation fall short of what we might now consider a well-designed financial regulatory regime? This assessment is carried out in the din of an ongoing debate about the method, extent, and even feasibility of financial regulation. If even after five years of analysing events since 2007, there is as yet no clear consensus on financial regulation, we cannot be too harsh in judging Labour’s record. Section VII concludes.

## **II. THE RATIONALE FOR FINANCIAL REGULATION**

The financial system plays an important role in enabling the transfer of resources across individuals and over time (say, from savers to investors), and

across ‘states of nature’ (through, say, insurance contracts). While financial markets are essential for efficient resource allocation, they suffer from well-known imperfections that can lead to market failures. For instance, information asymmetries can inhibit direct financing – small agents buying stocks and bonds directly. In such circumstances, deposit-taking banks with the ability to screen and monitor borrowers can act as intermediaries to facilitate transactions.<sup>2</sup> However, the behaviour of financial intermediaries is itself vulnerable to moral hazard and adverse selection.

One objective of financial regulation is to protect individuals in their financial transactions. *Caveat emptor*, the adage that ‘the buyer beware’, has limited traction if buyers are unable to assess the true characteristics of financial products, and especially when these characteristics become evident only with the passage of time. For instance, individual customers typically lack the resources to monitor or audit the firms they deal with.<sup>3</sup> Given that any acquired information has a public-good aspect, they may prefer to free-ride on others, and in the aggregate this results in too little monitoring or auditing relative to the social optimum. This inability to monitor leaves individuals vulnerable to misconduct by firms, and may cause them to shy away from financial transactions. Regulations that protect customers from outright fraud and other forms of market abuse can increase efficiency by supporting the usual gains from trade. This may require licensing restrictions on who can act as a financial intermediary and on the operational behaviour of those who are so licensed.

The loss to consumers can be particularly large if the firms they transact with go bankrupt. With limited liability, if firms are partly financed by borrowing from agents who cannot effectively monitor them, they have incentives to choose relatively risky portfolios, with greater risk of bankruptcy. Banks, in particular, have very high leverage ratios<sup>4</sup> so this distortion can be quite large. Given this proclivity for excessive risk, there is a case for efficiency-enhancing regulation: banks are required to maintain some minimum ratio of equity capital to assets, and are subject to periodic monitoring and supervision to limit risk-taking. Such ‘microprudential regulation’ can make banks safer and protect all their creditors.

A second rationale for the prudential regulation of banks relates specifically to depositor protection. Banks typically finance long-term and/or illiquid investments using short-term liabilities such as demand deposits. Since they only hold a small part of their total assets in liquid form, a sudden surge of withdrawals can lead to their failure. This leaves a bank vulnerable to a ‘run’ in the event of confidence problems: if other depositors withdraw funds the

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<sup>2</sup> See Freixas and Rochet (1997) for a discussion.

<sup>3</sup> Campbell et al. (2011) point out that consumers may also be disadvantaged by cognitive limitations and insufficient learning through experience for transactions that are carried out only occasionally (e.g., acquiring a mortgage) and whose outcome is known with a long lag. The argument that ‘informationally-small’ agents require protection has been developed by Dewatripont and Tirole (1994).

<sup>4</sup> Leverage is defined as the ratio of assets to equity capital. A firm whose acquisition of assets is partly funded by external debt would have a leverage ratio in excess of 1.

rational response of any individual depositor is to withdraw their funds too. In such settings, depositor protection schemes play a valuable role by eliminating the incentive to withdraw funds purely because other depositors are doing so: by ruling out the 'run' equilibrium, it maintains confidence in the financial system.<sup>5</sup>

However, the design of deposit protection schemes creates its own distortions. In most countries, deposit protection schemes are operated as a form of mutual insurance among banks, often with an implicit or explicit guarantee provided by the public exchequer. Optimally the premia paid by individual banks for such protection should be sensitive to the riskiness of their portfolio, but information asymmetries make such fair pricing difficult. This too leads to distorted risk-taking incentives which potentially impose a negative externality on the deposit protection fund. Once again, imposing microprudential capital standards to minimise the risk of bank failure can be justified as reducing the risk of excessive claims on the deposit protection fund.

Even if microprudential regulation improves the safety of individual banks or other financial intermediaries, this *per se* may not be sufficient for systemic safety. Systemic failures can impose huge burden on taxpayers, as explicit (depositor protection) and implicit (bailing out 'too-big-to-fail' institutions) guarantees must be honoured. Further, as banks serve as repositories of information on borrowers, their failure can result in significant economic disruption.<sup>6</sup>

What are the sources of systemic risk? As Brunnermeier et al. (2009) note, the conventional view of systemic risk is based on the idea of interconnections among institutions. If bank A owes funds to bank B, and B in turn to bank C, then a default by A affects B negatively, which in turn hurts C, and so on, creating a 'domino effect'. However, calibrated simulations in the literature suggest that these domino effects are unlikely to be large. Indeed, viewing systemic risk purely as a domino phenomenon may have led financial regulators to underestimate the issue of systemic stability.

The recent financial crisis has highlighted other mechanisms that can endogenously amplify a small shock into a system-wide crisis. Consider the case where financial institutions must maintain some minimum ratio of equity capital to assets, either to adhere to regulatory standards or, even in the absence of regulation, to maintain the confidence of its debtors. If losses incurred in an economic downturn cause capital ratios to fall below target, these institutions must respond either by issuing new capital (which is difficult in a downturn)<sup>7</sup> or by selling assets. If many institutions are in similar trouble and all try to sell assets at the same time, this will depress the price of these assets. As assets are

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<sup>5</sup> Note that deposit protection offered to customers of a fully-solvent bank is, in theory, costless: it maintains confidence, but no payment is ever needed from the depositor protection fund.

<sup>6</sup> Bernanke (1983) finds that such loss of information had a significant role in propagating the Great Depression. For taxpayer burden of crises, see Reinhart and Rogoff (2009).

<sup>7</sup> As common stock has the most junior claim, investors are reluctant to contribute new capital in times of financial crises, especially as attempts to raise new capital often signal financial distress.

usually valued at market prices ('marked-to-market'), this, in turn, worsens measured leverage, requiring further sales, depressing prices even more. Shleifer and Vishny (2011) explore the implied 'fire-sale' externality that intermediaries impose on each other.<sup>8</sup>

Balance-sheet shrinkage also means banks make fewer new loans, giving rise to a credit crunch. Indeed, a substantial body of evidence shows that banks reduce lending in the short run in response to higher capital requirements.<sup>9</sup> It follows that microprudential safety measures by themselves do not promote either systemic stability or optimal credit provision. 'Macroprudential regulation' attempts to get to grips with this systemic problem, through some form of contingent capital requirement, time-varying capital regulation scheme, or other schemes.<sup>10</sup>

Moreover, the prudential regulation of banks may also be inconsistent with the goal of systemic safety due to the so-called boundary problem. Regulated intermediaries have an incentive to circumvent regulation by relocating their activities outside the regulatory boundary. The 'shadow-banking' sector that comprises hedge funds, broker-dealer funds, etc., has a financing model that is in many respects similar to a deposit-taking bank (e.g., buying asset-backed securities funded with short-term credit). A key difference from conventional banks is the absence of any deposit protection, which implies they are vulnerable to a bad 'run' equilibrium in which short-term lenders refuse to rollover short-term debt.<sup>11</sup> The large size of this sector,<sup>12</sup> its complex web of transactions that are often intertwined with those of the banking sector, and its fragility, all make it a systemically-important sector. If tougher regulation of banks simply encourages a shift of intermediation into the shadow banking sector, it may fail to have the desired impact, or may even prove to be counter-productive.

Finally, we should note two important caveats that tend to be neglected in the literature on financial regulation. First, the conventional textbook picture of banks represents only a fraction of the activities of many large modern banks, which earn large parts of their revenue from other activities, most notably investment banking and derivatives trading. Second, a very large component of financial intermediation is carried out by pension funds and unit trusts, whose pattern of maturity transformation differs from that of banks: while banks have relatively illiquid assets compared to liabilities, a pension fund is typically in the opposite situation with long-term liabilities matched by portfolios of highly

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<sup>8</sup> See also Hanson et al. (2011).

<sup>9</sup> See, for example, Hancock and Wilcox (1993, 1998), Peek and Rosengren (1997). Whether there are longer term costs of higher capital requirements is less clear. See Kashyap et al. (2010) for a discussion of the issue.

<sup>10</sup> See Kashyap et al. (2011) for a discussion of several types of macroprudential policies. See also the Squam Lake Report (2010).

<sup>11</sup> See Gorton (2010), Gorton and Metrick (2010) for a discussion of the run in the repo market in the run-up to the recent crisis.

<sup>12</sup> Based on US data, Pozsar et al. (2010) estimated the size of the shadow banking sector at \$20 trillion in March 2008, falling to \$16 trillion at the start of 2010, which is still larger than the size of the banking sector (around \$13 trillion).

liquid securities. In the absence of short-to-long maturity transformation, the sector does not face liquidity risks similar to banks, and therefore similar systemic concerns do not arise here.

### **III. FINANCIAL REGULATION IN THE UK BEFORE 1997**

Unlike the United States, where the structure of statutory financial regulation was established in the aftermath of the Great Depression, regulation in the UK evolved more organically. As Goodhart (2000) points out, during much of twentieth century UK's financial industry evolved as self-regulating, 'cartelised clubs' of semi-specialised intermediaries. To the extent that cartels averted major financial failures, this obviated the need for external regulation. The Bank of England Act 1946, which nationalised the Bank of England, gave it only the powers to 'request information from and make recommendations to bankers'; it had some powers to issue directions to bankers, but as Robb (1997) notes, no such directions were ever issued under those powers.

The evolution of regulation in the second half of the century was largely reactive, with major regulatory initiatives typically following episodes of financial failure or scandal. Over time increased international competition and financial innovation blurred the distinctions between different lines of financial activity, straining the profitability of banks and increasing the risk of failure. This, by itself, made a case for more formal regulation. Moreover, following UK's entry into the European Economic Community in 1973, and the growing presence of foreign banks' subsidiaries and branches in London, there was a need to harmonise bank regulation with that in other countries. In 1974 the Bank of England invited the larger banks to submit to voluntary supervision.

However, it was only in 1979, with the first UK Banking Act, that the Bank of England acquired any legal powers and sanctions over banks. The Act created the statutory requirement that deposit-taking activity be restricted to authorised institutions. The Banking Act of 1987 enhanced the Bank's supervisory powers, especially its power 'to investigate and seek information', and also reinforced the deposit protection scheme that had emerged in 1982. It is striking that the existing legal framework for banking supervision had only been in place for 10 years before Labour came to power.

These enhanced supervisory powers were tested by the collapse of Bank of Credit and Commerce International (BCCI) in 1991 and of Barings Bank in 1995. In both instances, there were reactive changes in regulation. BCCI's collapse led the Bank of England to set up a Special Investigations Unit to guard against fraud; while the collapse of Barings, caused by trading losses of an overseas subsidiary, led the Bank of England's Board of Banking Supervision to call for tighter regulation of banking groups that also engaged in non-banking lines of business.



Alongside episodic regulation in reaction to crises, there was a steady process of structural deregulation, with the progressive removal of barriers between different markets. The so-called Big Bang reforms of 1986 had a marked impact on market structure. By eliminating fixed commissions on securities trades and removing the traditional distinction between 'stockjobbers' and stock-brokers, they allowed investment and clearing banks, both domestic and foreign, to buy out members of the stock exchange, enabling the creation of financial conglomerates. Restrictions on building societies, which had evolved as mutually-owned entities that used retail savings to make mortgages loans, were also relaxed. The 1986 and 1996 Building Societies Acts allowed them to compete with conventional banks in offering payment and other banking services. At the same time conventional banks began to compete with building societies in the market for mortgages. A wave of 'de-mutualisations' of building societies further blurred the distinctions between building societies and banks.

Historically non-bank financial services were very lightly supervised, with regulation restricted to legislation against outright fraud. Licensing requirement, when they existed, were modest and allowed significant exemptions.<sup>13</sup> Once again, there were instances of reactive regulation, such as attempts to improve consumer protection in response to the collapse of some insurance companies.<sup>14</sup> But the broad approach eschewed statutory regulation. The Financial Services Act 1986 came to rely on a collection of sector-specific 'self-regulatory organisations' (SROs).<sup>15</sup> An over-arching body, the Securities and Investment Board (SIB) was created for the oversight of these SROs.

There were some highly publicised failures of self-regulation, most notably in the pensions industry. In the late 1980s and early 1990s, many people were encouraged to transfer from defined-benefit occupational pension schemes to personal schemes. The commission-driven sales drives for such products, often to the long-run financial disadvantage of customers who lacked the ability to assess them, came to be known as the pensions mis-selling scandal. There were also instances of outright fraud, such as the discovery that the pension fund of the Mirror Group of Newspapers had been bankrupted by Robert Maxwell. Such events cast a long shadow on reputation of the financial industry.

In summary, as Labour came to power in 1997, UK's financial regulatory regime relied largely on self-regulation and was institutionally fragmented. Banks were supervised by the Supervision and Surveillance Division of Bank of England under the Banking Act of 1987. Building societies, though increasingly similar to banks, were supervised by the Building Societies Commission. Insurance companies were regulated by a division of the Department of Trade and

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<sup>13</sup> For instance, dealers in securities were subject to licensing requirements, but members of the Stock Exchange, deemed to be 'financially sound', were exempt from this requirement.

<sup>14</sup> The collapse of Fire Auto and Marine in 1966, and of Vehicle General in 1971, led to the Insurance Companies Act in 1974 and the Policyholder Protection Act 1975.

<sup>15</sup> These included, inter alia, the Securities and Futures Authority (SFA); the Investment Management Regulatory Organisation (IMRO) for fund managers; the Personal Investment Authority (PIA) for financial advice.

Industry, except Lloyds which was self-regulated. The securities sector had a two-tier system with self-regulatory organisations under the overarching supervision of the SIB. Some activities, such as trade in futures were not regulated, as futures were not classified as securities under contemporary legislation. The potential inconsistencies of multiple self-regulatory bodies and the emergence of financial conglomerates that straddled these different activities made a natural case for consolidation of regulation. Further, as the emerging mis-selling scandals demonstrated, the self-regulatory regimes had very visibly failed to control the conduct of some market participants. By the time Labour took over, there was a growing sense that statutory regulation might be inevitable.

#### **IV. REFORM OF FINANCIAL REGULATION UNDER NEW LABOUR**

Almost immediately on coming to power in 1997, the Labour government announced operational independence for monetary policy to the Bank of England, a move later formalised under the Bank of England Act 1998. This was accompanied by significant redesign of the architecture of financial regulation. The precise rationale for the redesign was never fully articulated, although the Labour party's 1997 election manifesto mentioned the pension mis-selling scandal and the need for better consumer protection. Post-election policy statements made a case for a replacing the self-regulatory structure with a consolidated statutory regime, bringing 'the regulation of banking, securities and insurance under one roof', with the intention of simplifying regulation and making it more effective.<sup>16</sup>

We discuss three salient aspects of Labour's regulatory reform. We begin by identifying the key features of the institutional structure they created. We then examine the specifics of the prudential regulation of banks in the new structure. Finally we discuss what we call the choice of regulatory intensity, in view of the frequent assertion that the regulatory regime turned out to be 'light-touch'.

##### **(a) The institutional design of financial regulation**

Soon after Labour came to power, the government set up a new body, the Financial Services Authority (FSA), as a successor organisation to the existing Securities and Investment Board. FSA took over the supervisory function of eight other bodies, including the various self-regulatory organisations, but most notably the banking Supervision and Surveillance Division of the Bank of England. Later, in 2004, the FSA also assumed the regulation of mortgage lending and in 2005, the regulation of general insurance.

The role and responsibilities of the FSA were not legally defined until the Financial Services and Markets Act 2000. Under this Act, the FSA's statutory objectives were to maintain confidence in the financial system, to promote public

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<sup>16</sup> Chancellor of the Exchequer in the House of Commons, 20 May 1997, *Hansard*, 509-510.

awareness of the financial system, consumer protection and the reduction of financial crime. Together these entailed a wide remit: regulation of deposit taking, of safekeeping of assets, and of those managing investments and providing investment advice; the establishment of a single authorization regime for all regulated activities; introduction of sanctions to restrain abuse of markets; and the establishment of the Financial Service Compensation Scheme, to unify the previously separate schemes for banks, building societies, insurance companies, and securities and investment firms.

While the creation of the FSA streamlined regulatory oversight for most sectors of the financial industry, it muddied the picture for bank regulation. The new arrangement created a tripartite system for regulation of banks, which involved the FSA, the Bank of England and the Treasury. The FSA had the responsibility for micro-prudential regulation of banks, but it was unclear whether its objective of 'maintenance of confidence in the financial system' amounted to what we might now understand as a macroprudential objective. The Bank of England Act 1998 gave the Bank an objective '*to contribute to* protecting and enhancing the financial stability of the UK'; but it was not entirely clear how the Bank's financial stability objective articulated with the FSA's micro-prudential functions: notably there was no direct FSA representation on the Bank's Financial Stability Committee. The Treasury was responsible for 'the overall institutional structure of financial regulation and the legislation which governs it'. There were various memoranda of understanding under which, in a systemic crisis, the FSA and the Bank would decide jointly whether any action from the Treasury was called for. As we discuss below, this tripartite system was found wanting in the early stages of the financial crisis of 2007-8.

### **(b) Prudential regulation of banks**

The prudential regulation of banks in the UK and overseas has been built around the imposition of minimum capital requirements on individual banks. The Basel Committee on Banking Supervision has sought, since 1988, to achieve international convergence in capital standards, by devising suitable risk-adjusted capital requirements.<sup>17</sup>

The 1988 Basel Accord set minimum capital requirements at 8% of a bank's risk-weighted assets, with assets assigned to one of four risk buckets. Under criticism that this constructed too crude a measure of risk, and covered only credit risk, the Committee amended the rules in 1996 to incorporate market risk too. The rules were overhauled in 1999, creating a new framework that came to be known as Basel II, based on three pillars. The first pillar on minimum capital requirements incorporated additional categories of risk (such as market risk and operational risk), but allowed greater flexibility in the measurement of risk, including reliance on banks' own risk-management models. The second pillar

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<sup>17</sup> Basel Committee proposals are not legally binding, but the 27 member countries, and some others, are expected to enshrine the proposals in their national regulatory framework.

stressed supervisory review of the capital position of banks and the third pillar encouraged banks to disclose information.

From the early 1990s the UK regulatory regime used Basel I rules as the minimum benchmark for its regulatory framework. The Basel II framework was formally adopted in the UK in 2006.<sup>18</sup> The UK regulatory regime was (and remains) somewhat unique in that the FSA continued the Bank of England's practice of setting *bank-specific* 'trigger ratios:' minimum capital ratios at levels *above* the minimum Basel requirements, reviewed every 18 to 36 months. A breach of the trigger ratio is regarded as a serious regulatory violation, leading to severe regulatory intervention and potential loss of licence. The Bank of England used to set a 'target ratio' above the trigger ratio, with the idea that shortfalls relative to the target would attract regulatory attention on the bank. The FSA discontinued the use of the target ratio, adopting instead the more informal policy of encouraging banks to hold a capital buffer above the trigger minimum.

### **(c) Regulatory intensity**

It has been argued, often with the benefit of hindsight, that Labour's financial regulatory regime was 'light-touch'. This characterisation, whether accurate or not, must be considered in a historical context. The 1990s witnessed much celebration of free-market capitalism, with rapid financial innovation and financial services emerging as a growth sector in Anglo-Saxon economies. The mid-1990s were also a period of considerable anxiety about the City of London's status as a global financial centre. UK's undignified exit from the Exchange Rate Mechanism in 1992, and the subsequent reluctance to adopt the Euro had created the fear that the City might be left outside the European mainstream. The established financial institutions in the City used their considerably lobbying power to make a case for less intrusive regulation. The idea also received intellectual legitimacy from the then-popular Greenspanian notion that the self-interest of financial institutions can provide self-restraint that makes regulation unnecessary. In the US, with its long history of financial regulation, the Gramm-Leach-Bliley Act (1999) had broken down the Glass-Steagall separation of investment from commercial banking.

Besides, the newly-elected Labour government had a particular desire to appear market-friendly. The Labour party's weak reputation for economic management, based on the experiences of the Callaghan government in the late 1970s, had damaged the party in electoral terms all through the 1980s and early 1990s. Meanwhile, the long period of Tory government from 1979 to 1997 had changed the economic landscape irrevocably, with Big Bang reforms in the City and the many privatisations of state-owned utilities. By the mid-1990s the Labour party was eager to adopt and proclaim new business-friendly credentials.

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<sup>18</sup> In the aftermath of the recent crisis, a new set of rules ('Basel III') have been proposed, partly adopted in the UK by 2012, and to be fully adopted in the future.

This mindset shaped Labour's reform process. While the shell of FSA was created almost immediately, legislative process was carefully staged, inviting consultation with all stakeholders. The City expressed considerable opposition to the 1998 draft bill, arguing that it gave too much authority to the FSA, making it the 'prosecutor, judge and jury'; and that its proposal to impose unlimited penalties for poorly-defined categories such as 'market-abuse' amounted to a draconian restriction of the free-markets approach. It was claimed that introducing such regulation in the UK would undermine the City's competitive advantage and possibly reverse the spectacular gains achieved in the post Big Bang period. In response, numerous amendments were made, essentially diluting the regulatory powers of the draft bill.

The consolidation within the FSA of previously-fragmented regulation was intended to generate efficiency savings by avoiding duplication of tasks and due to economies of scale and scope in supervision. But the desire for a less intrusive, risk-based regulator also made a case for a smaller body. The total administrative costs of financial regulation in the UK were indeed low, certainly in comparative terms, but arguably also in absolute terms. Jackson (2007) reports that in 2004 the FSA employed about 3000 regulators, low in comparison to the US, where the various federal and state agencies employed about 30,000 employees, a low number even if we allow for the smaller size of UK's economy or its financial sector. When comparing the regulatory budgets for supervision of banking, the contrast was particularly stark: the US spent roughly \$247,000 per billion dollars of banking assets while the equivalent number for the UK was only \$18,000.

This low-cost approach was not just an outcome, but a deliberate feature of regulatory design: as FSA (2011) points out, as late as 2005, the Chairman of the FSA was at pains to reassure the Prime Minister that the FSA applied to the supervision of its largest banks only a fraction of the resource applied by US regulators. To some extent the economy of expenditure reflected the efficiency gains from consolidation of regulation, and a historically-conditioned reliance on a culture of voluntary disclosure rather than intrusive regulation. But, even though the US regulatory system did not perform much better despite their greater expenditure, later events suggest that these economies may have constrained regulatory effectiveness in the UK.

## **V. THE FINANCIAL CRISIS**

The adequacy of UK's regulatory structure was not seriously tested until a crisis hit. Unlike previous crises, the financial crisis of 2007-8 was on a global scale, and caused much larger casualties in the UK financial sector. We assess the impact of the crisis on the UK, and the effectiveness of regulation, by focusing on two key events: the collapse of Northern Rock in 2007 and the near-collapse and subsequent recapitalisation and support for the Royal Bank of Scotland Group in 2008.

## **(a) Northern Rock**

Originally a mutually-owned building society, Northern Rock had traditionally made mortgage loans financed by members' savings. After becoming a Bank in 1998, it came to rely increasingly on short-term borrowing from wholesale money markets to finance its mortgage base. Its business model, based on extreme maturity and liquidity transformation, allowed Northern Rock to expand dramatically: its total mortgage assets grew from £17.4bn in 1998 to £113.5 bn by 2007, making it the then fifth-largest bank in the UK by mortgage assets.

When wholesale funding markets were hit by a liquidity crunch in the summer of 2007, Northern Rock was unable to renew its short-term loans. It sought liquidity support from the Bank of England, but this was initially hampered by concerns about transparency and by perceived legal constraints.<sup>19</sup> The Bank did eventually provide considerable liquidity support – Northern Rock's liability to the Bank rose to £28.5bn in due course – but the delay and the public revelation of emergency support, combined with inadequate depositor protection triggered a much-publicised bank run among its retail depositors in August 2007 – the first in the UK for nearly a century.<sup>20</sup> As Shin (2009) points out, the depositor run was not, however, the cause of Northern Rock's problems. Rather it was the 'run' by money market funds that had pushed Northern Rock to the brink of failure.

The crisis at Northern Rock exposed several weaknesses in the regulatory structure, a point further developed in the next section.

First, regulation failed to take account of the severe liquidity risk in Northern Rock's business model. FSA had allowed Northern Rock to move to the Basel II regime in 2007, enabling it to use its internal model to evaluate risk. While the bank nominally met the target for tier-1 capital, its capital position was weak relative to the true risk characteristics of its balance sheet. FSA's supervision of Northern Rock was quite poor too. As admitted in FSA's own internal report (FSA, 2008), for a prolonged period the bank was supervised by a department whose primary regulatory responsibility was for insurance groups rather than

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<sup>19</sup> The testimony of the Governor of the Bank of England to the House of Commons, 20 September 2007 cited legal difficulties due to the Takeover Code (which made a rapid takeover impossible) and the Market Abuses Directive in 2005 (which ruled out covert lending).

<sup>20</sup> Both newspaper reports and subsequent academic coverage described the run on Northern Rock as the first run on a UK bank since the collapse of Overend and Gurney in 1866. We are embarrassed to report that our own institution, Birkbeck College, is linked to the more recent run on Birkbeck Bank in 1910. As Clarke (2009) recounts, the bank was originally created to supplement the income of the London Mechanics Institute, forerunner of Birkbeck College, and in due course took over its premises entirely. On the basis of strong growth, it even built a grand new headquarters, complete with a dome bigger than that of the Bank of England. In a familiar historical pattern, the extravagant new building was completed only nine years before rumours about Birkbeck Bank's financial position set off a run by depositors in 1910. While the run was initially contained, payments had to be suspended in 1911. The Bank of England stepped in, but depositors were paid only half of the value of their £12.3 million in deposits (equivalent to around £800 million in current prices). An additional twist is that Birkbeck Bank was ultimately purchased out of receivership by the London County & Westminster Bank, forerunner of NatWest, ultimately taken over by RBS.

banks. Even where risks were identified, these were not effectively pursued, and lapses blamed on high turnover of regulatory staff and shortage of expertise. Given the low resource base of the FSA, noted above, this weak performance is not surprising.

Second, the fragmentation of supervisory information and crisis-management tools, inherent in the tripartite structure, was bound to create loss of coordination in the event of crises, leading to delays in rescue action by the Bank of England. Once the announcement of Bank of England's liquidity support came to be regarded as 'bad news', the incompleteness of depositor protection made a run rational for most depositors. At the time, deposit protection in the UK was limited to the full value of deposits up to £2000, and only 90% of any further holdings up to £35,000. Regulatory inaction allowed the run to continue for three days in August 2007 before it was ended by the announcement of full deposit protection up to £50,000.

Subsequent events, however, showed adept improvisations by the government, for which it deserves credit. Northern Rock was probably solvent but illiquid, though some of its mortgage assets were perceived as risky against a background of declining house prices. Separately its funding remained vulnerable to 'rollover risk'. Given that governments can take a longer-term view and face no rollover risk, the nationalisation of Northern Rock in February 2008 was probably a sensible step. In 2010, the bank was split into two parts: one part (Northern Rock plc) with the highest quality mortgages and savings accounts was sold to Virgin Money, while the other part, with £50 billion of mortgages was retained, to be gradually wound down in public ownership. We argue below that support provided to Northern Rock was critical for maintaining confidence in the financial system, and, at minimal cost to the exchequer.

### **(b) Royal Bank of Scotland**

Before the crisis hit, the Royal Bank of Scotland (RBS) had been widely regarded as a model of success in the new financial boom. Though RBS started as a relatively small player, its assets grew dramatically through a series of acquisitions, most notably a hostile takeover of the much larger Natwest Bank in 2000. Its expansionary streak continued through much of the decade, from the acquisition of a 10% stake in the Bank of China in 2005, to participation in a consortium to take over the Dutch bank ABN AMRO in 2007.

However this rapid expansion was achieved at a cost. Its expansion had been financed to a significant extent by debt, much of which was, like Northern Rock's, short-term in nature. Its acquisition of ABN AMRO was carried out with minimal due diligence and resulted in a very significant increase in effective gearing. It incurred significant losses in credit trading (much of it in structured credit) and impairments on loans. Its capital position was too weak to absorb the losses on its trading activities, even though it met the (then low) regulatory standards. The FSA did push RBS to recapitalise through a £12bn rights issue in June 2008, but even thereafter it remained very short of capital.

These troubles were not unique to RBS. As large classes of asset-backed securities lost value, several UK banks posted large losses and saw sharp falls in share prices.<sup>21</sup> The UK banking sector was experiencing a system-wide problem, but RBS was particularly badly hit. As documented subsequently by the FSA (FSA, 2011), markets were not simply responding to the (notionally still manageable) losses that RBS had already recorded, but were anticipating (as it turns out, correctly) further large losses in the future. By late 2008, RBS's share price had lost 95% of its value at its peak in early 2007.

To avoid a full-blown systemic crisis, the Labour government responded with a large programme of recapitalization and liquidity support for the financial sector in 2008. These involved capital injections of (ultimately) over £45bn in RBS and over £20bn in the Lloyds Banking Group. Further, a Credit Guarantee Scheme was set up to guarantee short- to medium-term debt issued by eligible banks in the wholesale markets against a fee. This was intended to eliminate rollover problems, and, in turn, to restore confidence to the interbank market. Finally, at least £200bn was made available to banks under the Bank of England's Special Liquidity Scheme. The scheme allowed banks and building societies to swap illiquid financial assets including mortgage-backed securities, for Treasury bills. At its peak, government support for the banking sector, both in terms of cash and in terms of contingent liabilities, exceeded £1 trillion.

To what extent was there regulatory failure? The FSA's (2011) report into the failure of RBS acknowledged some of its own failings: citing an 'inadequate focus on the core prudential issues of capital, liquidity, and insufficient willingness to challenge management judgements and risk assessments.' But it also concluded that the 'key prudential regulations applied by the FSA, and by other regulatory authorities across the world, were dangerously inadequate'.

Once again, while regulatory failure contributed to the crisis at RBS, the government's subsequent handling was better. Having realised, after the Northern Rock episode, that delay and policy confusion only exacerbate the crisis, by 2008 it responded to RBS and other banks' troubles with a massive programme of recapitalisation and liquidity support tools.

### **(c) Quantifying the costs of the crisis**

Who paid the price of the financial crisis? This is conceptually and practically a difficult question, and we restrict attention to the direct costs associated with failures, or near-failures, of UK banks. On this basis, at least, the summary picture is fairly clear. By far the greater part of the costs was borne, as indeed is the clear intention of banking regulation, by the banks' own shareholders. There were

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<sup>21</sup> In April 2007, there were nine UK banks in the FTSE 100 with a total market capitalization of £316.9 billion: Alliance & Leicester, Barclays, Bradford & Bingley, HSBC, HBOS, Lloyds TSB (later merged with HBOS to create Lloyds Banking Group), Northern Rock, RBS, and Standard Chartered. By April 2008, two of the banks had dropped out of the index (Northern Rock and Bradford & Bingley), and the combined market capitalization stood at £245.1 billion. By April 2009 it fell further to £138.1 billion.



significant costs to UK taxpayers too, although their ultimate value remains harder to quantify. In contrast, retail deposit-holders escaped largely unscathed, and bondholders largely managed to free-ride on deposit protection.

The National Audit Office (NAO, 2012) has assessed the costs of taxpayer support in some detail. Taxpayer support came in three forms, loans, contingent liabilities and direct equity investment. The NAO figures suggest that, *ex post*, the first two categories have not resulted in significant, or indeed quite possibly any, losses to the taxpayer. It appears likely that most loans (the bulk of which were to the remnants of Northern Rock and Bradford & Bingley) will be repaid, with cumulated interest at a rate that will exceed, by a fairly comfortable margin, the costs of the additional government debt required to fund them. And, while contingent liabilities (in the form of a range of government guarantees) peaked at over £1 trillion in 2008, they had already fallen to one tenth of this level by March 2012. With most such schemes expected to close in the relatively near future, it is quite likely that only a negligible proportion of contingent liabilities will actually be exercised. Indeed, the NAO estimate that, again, *ex post*, the taxpayer has made around £11bn in fees charged for the scheme.<sup>22</sup>

The taxpayer has however almost certainly lost out in terms of direct investment in new equity capital, mainly purchases of shares in RBS and Lloyds. As of March 2012, the market value of all taxpayer investments in shares of UK banks had, on NAO estimates, fallen by around £27bn, based on post-purchase share-price movements. To put this value in context, this capital loss is just under 2% of UK's annual GDP. Clearly the loss is significant but, in terms of international comparisons, the taxpayer costs of bank bailouts have usually been much higher (see Reinhardt and Rogoff, 2009). Equally importantly, by the time the taxpayer investment was made share prices of all banks, but particularly RBS and Lloyds, had already fallen quite dramatically. Thus by far the largest part of the losses was borne by the existing shareholders, predominantly pension funds. We calculate that investors in the major UK banks lost over £200bn (or around 14% of UK GDP) between early 2007 and early 2009.<sup>23</sup>

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<sup>22</sup> It is much more difficult to assess whether the fees charged for these schemes, and the interest rates earned on loans were, *ex ante*, commensurate with the risks borne by the taxpayer. The NAO estimates that there was an implicit subsidy of up to £5bn on the contingent liabilities, and around £2bn on the loans; but the magnitude of these estimates is highly dependent on the discount rate applied. One approach is to use a rate that markets would require to provide the same funding, and on this basis NAO chose 6% as the reference rate. However, unlike markets, governments face no rollover risk and can take a longer-term view, so that the market rate is likely to exceed the socially optimal rate. The government, for instance uses a rate of 3.5% in evaluating standard projects.

<sup>23</sup> This is based on estimated capital losses to equity investors in the (then) top 9 UK banks between April 2007 and April 2009, relative to UK GDP of £1.4 trillion in 2009. Calculations of losses to shareholders are of necessity imprecise, since they depend on the period chosen; however bank share prices had shown only relatively modest changes for some years before 2007, so calculations based on earlier initial investment dates would be fairly similar. For full details of calculation, see the Appendix.

In contrast, since virtually no UK banks (and no large ones) became officially insolvent, bondholders suffered only modest losses, essentially restricted to those holding subordinated debt or preferred equity.

Thus, at a crude estimate, the direct costs of the UK banking crisis to all stakeholders (i.e., taxpayers and shareholders) were of the order of around £225bn. At current valuations, an equivalent loss would be realised to investors in the UK stock market if it fell by 13% – less than one standard deviation on an annual basis.<sup>24</sup> This raises the intriguing question (beyond the scope of this paper) of why losses due to bank crises (which are, ultimately, redistributive, rather than aggregate losses) should have such large apparent effects on the economy as a whole.

## **VI. EVALUATION OF LABOUR'S RECORD**

How did the regulatory and institutional structure created by the Labour government perform, especially in the global financial crisis of 2007-8? In evaluating the regime, we distinguish between flaws which, in our opinion, could have been avoided on the basis of knowledge and understanding that were available at the time, and lessons that can realistically only be drawn with the benefit of hindsight.

### **(a) Evaluating the regulatory structure**

The Labour government's major initiative in combining fragmented self-regulatory bodies into a unitary statutory authority had the advantage of eliminating unnecessary regulatory overlaps.<sup>25</sup> FSA was set up as an entity separate from the Bank of England, which retained a role in maintaining systemic stability. These bodies, along with the Treasury, formed a tripartite regulatory structure.

The first question is whether the transfer of banking regulation from the Bank of England to the FSA was a sensible choice. In theory, all financial regulation could be consolidated within the central bank but, as Goodhart (2000) notes, this carries the risk that the central bank safety net would stretch to cover ever-widening range of financial activities. Further, where the central bank acquires operational independence in monetary policy, as the Bank of England did in 1997, the retention of supervisory functions may create conflicts of interest,<sup>26</sup> or

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<sup>24</sup> Using market capitalisation data in FT All-Share Index Factsheet, 31 October 2012.

<sup>25</sup> However, the regulatory landscape in the US provides a contrasting example. As Davies and Green (2008) summarise, there are over one hundred different financial regulators at federal and state levels. Even bank regulation is fragmented, between the Federal Reserve, the Office of the Controller of the Currency, the Office of Thrift Supervision, and fifty state banking regulators. Multiple regulators might encourage free-riding and lowers standards, but at the same time a fragmented structure is less vulnerable to regulatory capture.

<sup>26</sup> For example, the monetary policy division might call for tighter monetary policy, but this might be seen as detrimental to financial institutions by its regulatory division.

concerns that the combination of monetary policy and bank supervision might vest too much power in a body that is not elected.<sup>27</sup> On the other hand, if the central bank is to serve as the lender of last resort, it needs to act promptly in a crisis. As Taylor (1995) argued, any incompleteness in information transmission between the regulator and the central bank may lead to a delay in the latter's policy response, undermining stability.

On balance there is no compelling argument in favour of one structure or the other, and practice differs across countries. However, any chosen structure must provide a clear demarcation of responsibilities. The tripartite structure chosen by the Labour government fell short in this regard. In the absence of a clearly-identified macroprudential regulator, all parties in the tripartite arrangement had a role in ensuring systemic safety. Arguably, this seeming overlap in responsibility created an 'underlap': when everyone is responsible, no one really is.

The separation of supervisory information and crisis-management tools proved to be particularly problematic. While the FSA was responsible for supervision of individual banks, it lacked the tools to rescue a bank in trouble. The Bank of England had the ability to serve as the lender of last resort, but there were frictions in information transmission between the FSA and the Bank. As Plenderleith (2012) reports, the Bank had to rely on the FSA for data on banks' liquidity, and the data lacked the detail necessary for the Bank's operational response (such as emergency liquidity assistance).

The post-crisis reforms represent a switch to the 'twin peaks' structure advocated by Taylor (1995), with the creation of a Prudential Regulation Authority within the Bank and a Financial Conduct Authority to assume the other tasks currently carried out by the FSA.

### **(b) Evaluating microprudential regulation**

As the FSA concedes in its *Annual Report 2011-12*, its 'pre-crisis approach to prudential supervision was flawed, with insufficient resources devoted to the most important high-impact firms and inadequate focus on the core prudential issues of capital, liquidity and asset quality.' In some instances it failed in its responsibilities as a microprudential regulator (as in the case of Northern Rock), while in other instances the prevailing regulatory rules proved to be inadequate (as in the case of RBS).

The Basel I and II requirements specified a risk-weighted capital ratio of 8%, of which only 2% needed to be core tier-1 capital (common equity and retained earnings, both valuable in terms of their loss-absorbing capacity). Though the UK regulator's trigger ratios for overall capital were usually set above the Basel requirements, and the FSA even encouraged banks to have capital above the trigger ratios, there was no higher minimum set for core tier-1 capital. In the

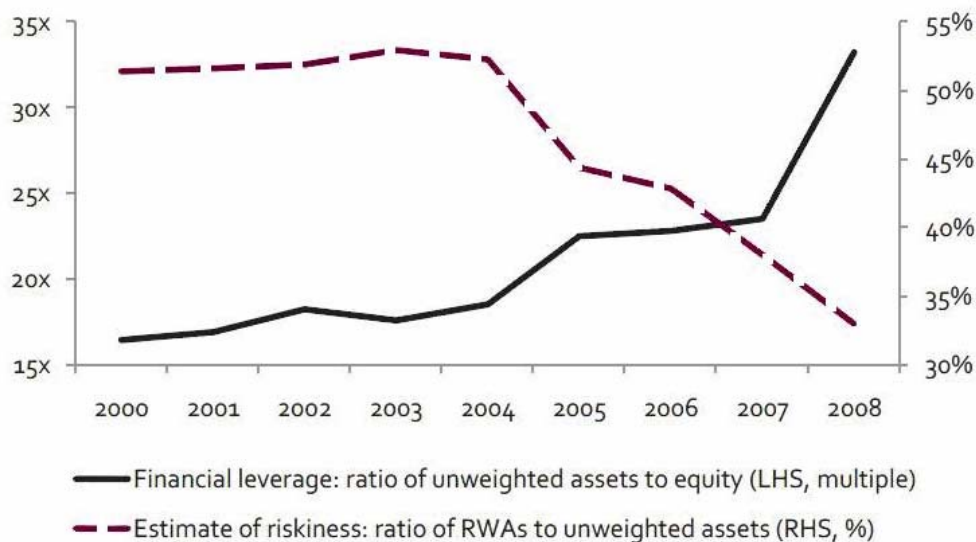
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<sup>27</sup> See Davies and Green (2008).

crisis the 2% buffer of high-quality capital proved insufficient. Further, while the FSA’s regime of bank-specific trigger ratios allowed them to vary across banks, the chosen values ignored any macroprudential concerns. Specifically, there was no systematic upward adjustment for systemically-important banks.

However, given the benign macroeconomic environment of Labour’s first two terms, with the UK experiencing one of the longest stretches of sustained growth, it is unlikely that the FSA could have pushed for tighter prudential regulation. As late as 2007, the Bank of England’s *Financial Stability Report*, while acknowledging the warning signs from the sub-prime market, asserted that the ‘UK financial system remains highly resilient’. If the FSA had raised capital requirements significantly, UK-based banks would have complained (and probably effectively) that their competitiveness was being put at risk by a heavy-handed regulator.

**Ratio of risk-weighted assets to unweighted assets falls as financial leverage increases (aggregated for the four largest UK-headquartered banks)**



Source: Financial statements of Barclays, HSBC, LBG and RBS

**Figure 1**

Source: Independent Commission on Banking, Interim Report, April 2011

This brings us to the issue of risk measurement. A wave of financial innovation had created complex financial derivatives whose risk characteristics were misunderstood by market participants and regulators worldwide, not just in the UK. As Figure 1 shows for the four largest UK banks, while leverage grew quite dramatically in the run-up to the crisis, measures of risk-weighted assets grew more slowly than un-weighted assets. In a classic instance of “Goodhart’s Law”, as regulators targeted risk-weighted assets this measure became largely useless as an indicator of the financial risk carried by a bank. The problem was made

worse by the adoption of Basel II in 2006 which allowed banks to use their internal risk-measurement models to evaluate risk. But the FSA was merely conforming with internationally-agreed standards, so it is difficult to apportion blame.

The crisis has also shown that prudential regulation failed to appreciate the importance of liquidity, both on the asset side (holding sufficient liquid assets) and on the liabilities side (reduced reliance on short-term funds). Regulation of liquidity was not part of Basel II; neither did the UK regulator pay attention to potential liquidity problems faced by banks. Once again, this outcome emerged from a global regulatory framework, so it is unfair to single out UK regulators for criticism.

In the aftermath of the crisis, the Basel Committee has advocated tighter regulation of both capital and liquidity. Under Basel III, while the capital requirement would remain at 8% of risk-weighted assets, the mix of required capital would change: core tier-1 capital would increase from 2% to 4.5%, and rise to 9.5% for the banks with most systemic importance (as, for example, RBS would have been in 2008). While such tighter regulation would have given greater protection in the last crisis, these changes bear all the hallmarks of a 'shutting of stable doors after the horse has bolted'. It remains to be seen how effective they will be in the next crisis. Haldane (2012), for instance, notes that, before the crisis, regulated capital ratios would have given absolutely no signal of which banks were most vulnerable.

### **(c) The design of deposit protection**

Labour's reforms of financial regulation revealed a lack of understanding the role of effective mechanisms for compensating individuals in the event of financial failures. As regulation of all financial intermediaries was consolidated under the FSA, there was a natural logic to the consolidation of all protections schemes under a common umbrella, namely the Financial Services Compensation Scheme (FSCS). However, the design of the deposit protection scheme turned out to be poor, an inadequacy that reflected both complacency and a lack of appreciation of the rationale for such schemes.

When the Labour government took office in 1997, customers of financial institutions were protected under a variety of sector-specific schemes. Retail deposits in UK banks were protected under the Deposit Protection Scheme, while savings in building societies had a separate scheme.<sup>28</sup> A striking feature of these pre-existing protection schemes in the UK was the relatively small value of aggregate payouts. Over the period 1982 to 1996, aggregate net payouts from the Deposit Protection Scheme for UK banks were only £88 million; not a single payout was ever made on the equivalent scheme for building societies. Compare

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<sup>28</sup> The Building Societies Investor Protection Scheme offered levels of protection similar to the banks' scheme. The Investors Compensation Scheme protected individuals against the failure of investment firms and insurance contracts were protected under the Policyholders Protection Scheme.

this to the US figure where payouts under the deposit protection scheme were of the order of \$30 billion over 1986 to 1995: a massive contrast even correcting for the relative size of the two economies.

Two features of the UK scheme for deposit protection are particularly relevant. First, in the run up to the crisis, deposit protection was less than complete: while deposits less than £2000 were fully guaranteed, protection was limited to 90% of the value of deposits between £2000 and £35000, and nothing beyond.<sup>29</sup> The implied 'co-insurance' was viewed as a deliberate design feature of these schemes to maintain a balance between consumer protection and *caveat emptor*, specifically to preserve depositors' incentives to monitor the soundness of banks they dealt with. The desirability of maintaining only partial coverage was reviewed by the FSA at the inception of the FSCS (see FSA, 1997), and re-affirmed as recently as 2005.<sup>30</sup>

While partial coverage does sharpen incentives for depositors to monitor banks it stretches belief that individuals can be sufficiently informed in settings where even the FSA, with access to statutory powers to demand disclosure, was unable to do so. Recall that the purpose of deposit protection is not just the compensation of depositors in the event of bank failure, but also the role that the promise of compensation can play in eliminating inefficient panic-induced bank runs. Providing *complete* deposit protection up to some reasonable limit is critical for this latter function.<sup>31</sup> A scheme that offers only partial deposit protection fails in its objective of maintaining confidence in banks.

Second, on the arrangements to fund compensation payouts, the UK schemes were designed to be pay-as-you go rather than pre-funded. While the cost of a bank's failure is borne by surviving banks, the compensation can be made by creating an ex-ante fund to meet future payouts or through an ex-post levy after a bank failure. The UK scheme was set up as an ex-post arrangement, with the FSCS maintaining only a small fund to meet its administrative expenses and, since levies were normally imposed only once every 12 months, to ensure speedy compensation in the event of small failures in the next year.

It is interesting to compare both features of the UK system with the USA, where the Federal Deposit Insurance Corporation (FDIC) provided 100% deposit protection on deposits up to \$500,000. To fund this level of protection, it was also required by law to maintain a substantial Deposit Insurance Fund: under current legislation, the target value of the fund is 1.35% of the insured funds, a ratio in the same ballpark as the Basel II tier-1 capital requirement. Further the premia collected by the FDIC are risk-based so that banks that are deemed risky

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<sup>29</sup> Even this was a considerable improvement over the original Deposit Protection Scheme, which covered only 75% of deposits up to £10,000 (Jackson, 1996).

<sup>30</sup> As FSA (2005) put it, 'The UK authorities believe that allowing consumers to bear an acceptable level of the cost should an institution fail, represents a proportionate way to address moral hazard.'

<sup>31</sup> The upper limit preserves co-insurance for large depositors who are better able to monitor banks.

pay higher premia on their assessed deposit base. While risk assessments may be less than perfect, this arrangement provides at least some deterrence against banks' assumption of risk.<sup>32</sup> An ex ante fund also corrects for cyclical, transferring compensation resources from good times to bad ones.

A further problem in the UK is the absence of proper exit rules. In the US, the existence of a large fund enables FDIC to assume immediate control of a failing bank, ensuring that depositors have continuous access to their funds. The UK scheme promised only to compensate customers within three months, potentially severely impairing the liquidity of bank deposits.

Many of these design features were well-understood at the time the FSCS was being designed in the UK (see, for instance, FDIC 1998), so these criticisms do not solely rely on hindsight. But these flaws became transparent during the run on Northern Rock. In the wake of that crisis, deposit protection was rapidly boosted to cover 100% of the first £50,000 (and further raised to £85,000 in 2011). But these responses only highlight the weakness of the original regime. The UK compensation scheme treated bank failures as very low probability events unlike, say, the FDIC which handles the (controlled) failure of banks as a regular occurrence. The designers of the UK scheme did not understand the purpose of deposit protection, and successive governments, the Bank of England, as well as the FSA failed to correct this basic mistake until after the damage had been done.

#### **(d) Conduct regulation under the FSA**

The FSA's statutory objectives included consumer protection and reduction of financial crime. Indeed, Labour's 1997 manifesto had explicitly mentioned the need to eliminate practices such as the mis-selling of personal pensions. However, on both accounts, FSA's record is mixed.

Till the onset of the financial crisis, the FSA had largely de-emphasized enforcement. As late as 2006, the FSA's Director of Enforcement asserted that FSA was 'not an enforcement-led regulator but one that uses supervision and on-going relationships with firms as its frontline means of regulation'. She claimed that 'London's philosophy of "light touch" regulation had helped it in becoming the world's leading centre for mobile capital', quoting statistics on how the London Stock Exchange had outperformed the New York Stock Exchange in terms of capital raised and the number of IPOs (see FSA, 2006a). The approach eschewed the 'heavy-handed use of rulebooks', instead relying on the voluntary disclosure of information in a culture that borrowed from its historic tradition of industry self-regulation. For instance, the FSA recognised the growing concerns about insider-trading and market manipulation, especially by hedge funds (which were outside the FSA's jurisdiction). Its own analysis (FSA, 2006b) found

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<sup>32</sup> The FSA's arguments for co-insurance, for example, cited the need to deter investors from putting deposits into banks offering high returns, reflecting high risks – the Icelandic banks being, with hindsight, a prime example. However, risk assessment by a deposit protection scheme could arguably have fulfilled the same function more effectively.

evidence of unusual price movements prior to a quarter of merger announcements, but the FSA nonetheless restricted its response to ‘surveillance’.

As a consequence of this approach, the FSA’s record of enforcement activity before the crisis was sparse. The FSA had the authority to seek criminal sanctions, but till as late as 2007 it largely restricted action to imposition of civil remedies. It had the ability to impose unlimited fines against firms and individuals, but actual fines were not too large, and often an inadequate deterrent. Before the crisis the largest penalties against firms included a £17m fine on Royal Dutch Shell in 2004 for misleading disclosures and a £33m fine on Citigroup in 2005 for market manipulation; the highest penalty on individuals over this period involved a fine of £750 thousand for insider dealing. The FSA has been far more aggressive in the aftermath of the crisis, both against individuals and firms – consider the recent, significantly larger, penalties for manipulation of LIBOR.<sup>33</sup>

When it came to consumer protection, once again the FSA’s record was far from stellar. Historically the UK has had a pattern of free deposit banking, forcing banks to cover their costs through other charges and cross-selling of other services to their retail customers. For instance, banks collected significant revenue from punitive charges imposed on customers who had overdrawn their accounts: the FSA dragged its feet on this issue, leaving the Office of Fair Trading to intervene in favour of small depositors. The FSA also did little to check the mis-selling of payment protection insurance (PPI) – supplementary insurance linked to credit contracts that aims to protect repayments in adverse events. PPI contracts were typically very expensive and riddled with hidden exclusion clauses, but sold aggressively to customers by commission-driven employees. Fines imposed by the FSA in the initial stages were too meagre relative to the large profits that banks made from selling PPI.<sup>34</sup> Having failed to regulate effectively in the first instance, the FSA has now ordered banks to compensate customers who were mis-sold PPI, and indeed, charges for PPI compensation are likely to dwarf any previously imposed penalty.

## VII CONCLUSIONS

To what extent did UK regulatory design under Labour meet the broad objectives of financial regulation? And, given that enforcement was delegated to the FSA, to what extent did it fulfil the task that was assigned to it?

On the microprudential front, the UK did try to implement a stronger version of the international benchmarks set out in the Basel proposals. With the benefit of hindsight we know that these international standards turned out to be quite

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<sup>33</sup> See FSA (2007). As Hinton and Patton (2011, 2012) report, before 2008-09, the FSA sought a cumulative total of only 11 indictments for criminal action with 8 convictions. In the three years after that it sought 31 more.

<sup>34</sup> At a public speech in 2012, Martin Wheatley, chief executive designate of the Financial Conduct Authority, conceded that “the FSA should have known firms (that) would not respond to £100,000 fines, as they were making billions from this market.”



inadequate, especially when it came to measurement of risk. The FSA's failure, shared with other regulators around the world, stemmed from excessive faith in these standards and ignoring other danger signals. Further, the enforcement of these standards was poor as evident from the failures in monitoring and supervision of Northern Rock and RBS.

Even as the FSA underestimated the risk of failure of individual institutions, its mechanisms to cope with actual failures had major design flaws. The design of financial compensation schemes was concerned largely with harmonising consumer protection across various classes of financial activity, from bank deposits to general insurance, ignoring the fact that the purpose of consumer protection varies across these activities. In particular, the scheme did not appreciate that partial coverage of retail deposits could leave the system vulnerable to bank runs. This and the absence of ex ante funding revealed ignorance both of contemporary economic theory and of practice in other countries. The failure of deposit protection arguably did much to dent confidence in the early stages of the financial crisis, and the government, the Bank of England, and the FSA must all share the blame for this.

On the macroprudential front, the failure lay in the ambiguous assignment of this regulatory responsibility within the tripartite structure. Nominally the Bank of England was in charge of maintaining financial stability but, once relieved of day-to-day banking supervision, the Bank became blinkered to the emerging systemic risks. However, we must not overstate this weakness: countries that did not have such separation, such as the US, did not fare better on the macro-prudential front.

On a more positive note, we would contend that, after a shaky start during the early stages of the crisis in 2007, the Labour government responded to the financial crisis quite effectively with a package of financial support for the banks. The direct costs to taxpayers of state support, while non-trivial, appear to have been limited to the costs of recapitalising two major banks. Crucially, by far the greater part of the costs of the reckless behaviour by some UK major banks was borne by their shareholders.

In contrast to the very visible failings of UK banking, we should also mention a Dog That Did Not Bark during the financial crisis that occurred under Labour. Losses suffered by intermediaries outside the banking sector, most notably pension funds and unit trusts, were borne by their ultimate beneficiaries; none were passed on to the taxpayer. The fall in the stock market in 2008 alone led to a reduction of \$228 billion in the value of total investments of pension funds and unit trusts,<sup>35</sup> a figure of a similar magnitude to the total losses in the UK banking sector during the crisis. These losses did not pose any major risk to the financial system and cannot be regarded as a failure of regulation. In contrast, the banking system, with its mismatch between the nature of its liabilities and its assets has been chronically prone to crisis.

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<sup>35</sup> *Financial Statistics*, July 2010, Tables 5.1b and 5.2d

This raises a larger question: can regulation prevent crises at all? Once we admit that the self-interest of financial players is not sufficient to prevent their failure, is it realistic to hope that well-designed regulation can mitigate this problem? The history of financial regulation under Labour underscores the difficulties of regulating a complex and continuously-innovating system. Regulation can at best hope to control risk in the system using crude measures; and even when the choice of measure seems sensible, it is vulnerable to Goodhart's Law: namely, that any regulatory target is likely to be gamed by the regulated entities, thus reducing the information content of the target. Since the financial crisis, alternative risk measures have been proposed – such as the 'raw leverage' of financial institutions – which, with hindsight, might have done a better job than the measures actually employed before the crisis. But it is easy to imagine that any alternative measure might well have spawned its own distortions.

There is also the issue of the boundaries of regulation. The very act of regulation inevitably creates incentives for the relocation of activities outside the reach of the regulator. In the absence of regulation, activities in the shadow banking sector were more profitable in the upturn, but also more vulnerable to loss of confidence in the downturn. While some have argued that regulation should apply to all sources of systemic risk, implementing such policies would encounter practical difficulties.

Finally, we highlight two further lessons to be learnt from the experience of banking regulation under Labour. First, if there *is* to be more effective regulation in the future, it will almost certainly require considerably more resources than were invested under the Labour regime. With hindsight, the 'light-touch' regulation of this period simply meant that it was almost certainly severely under-resourced.

Second, the primacy accorded to regulatory concerns, as mediated by the political process, tends to vary with the economic cycle. When the economy is doing well, so does the financial sector. Regulators are typically unwilling or unable to take a very stringent stance, with concerns about competitiveness outweighing prudential concerns, especially when the economic boom is legitimised by a 'this-time-is-different' mindset. A benign environment also makes for easier regulatory capture by a wealth-generating financial sector. The pattern of regulation under Labour bears all the hallmarks of such tendencies, but in all fairness, governments in other major economies behaved in a similar fashion. In the aftermath of a crisis, regulation is inevitably tightened (often over-tightened) to address the perceived problems in the previous market exuberance. The incoming Coalition government also appears to be following this typical pattern. But the clear risk is that new problems will in due course arise that will again tend to render current regulation ineffective in preventing future crises.

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