UK Case Study – 'Globalisation: The Role of Institution Building in the Financial Sector'

1. Introduction

1.1 The role played by institutions in supporting economic growth has been subject to increasing interest over recent years. Liberalisation of the world's financial markets and increasingly globalised financial services bring considerable benefits. These include greater access to capital at lower cost, more competition and innovation, and greater efficiency. Greater openness often raises exposure to threats of financial instability, however. This reinforces the importance of strong and effective structures and frameworks, in particular credible monetary and fiscal policy frameworks supported by effective financial regulation.

1.2 This paper focuses on the UK's experience since 1997 of building new institutional structures and frameworks to deliver effective financial regulation and stability. It considers the drivers behind reform, the rationale for the new structures and frameworks, and lessons learnt.

1.3 The critical elements of the UK's reform process in the field of financial regulation were the separation of banking supervision from the operation of monetary policy; the creation of a single regulator that covers banking, securities and insurance; the establishment of a framework within which the regulator is independent from, but accountable to, Government in the pursuit of its statutory objectives; and a tripartite arrangement whereby the finance ministry, the monetary authority and the financial regulator meet regularly to discuss issues affecting the stability of the domestic and global financial system.

1.4 The UK has been a liberalised economy with mature financial markets for some time. The mechanics of liberalisation and market development are not addressed in depth in this paper. Limited reference is made to complementary institutional reforms to monetary and fiscal policy, which were subject to a separate paper submitted to the G20 by the UK in November 2002.[1]

[1] Macroeconomic Frameworks in the New Global Economy', HM Treasury, Nov. 2002 (http://www.hm-treasury.gov.uk/media/B6356/admacro02-249kb.pdf).

2. Short history of the UK situation pre-1997

Context

2.1 The liberalisation of capital markets in the UK has been extensive and long-running. Exchange controls were abolished in 1979. Direct controls on capital markets were dismantled subsequently. This included the removal of indirect controls on bank lending, the virtual abolition of bank reserve requirements, and deregulation of the securities market. Controls on mortgages and consumer credit were also relaxed. The UK is now one of the most open and liberalised capital markets in the world.

Previous Policy Approaches

2.2 The UK financial sector changed significantly following liberalisation as firms became increasingly integrated into global capital markets. The financial sector used to be subject to a mix of self-regulation, central bank supervision and government regulation.

2.3 From the early 1980s there was a shift away from informal self-regulation in the banking and securities sectors towards statutory regulation. Statutory regulation by the Government remained in the insurance and building society sectors, as it had been for some time.

2.4 This change arose because the self-regulatory system was vulnerable to industry regulatory capture, to the detriment of consumers. In addition, a large number of self-regulatory bodies created confusion both for the industry and for consumers. Pure self-regulation tends to be appropriate where organisational structures are simple, there is strong competition, goods and services are well-defined, and the public are well-informed. Some of these conditions no longer applied in the late 1980s.

2.5 During this period the ownership of assets such as housing, private pensions and shares was becoming increasingly widespread. The impact of financial scandals (such as pensions and mortgage mis-selling) was widely felt. This increased the pressure to reform the self-regulatory regime.

2.6 The Financial Services Act 1986 introduced some reform whilst retaining some of the benefits of self-regulation. The state provided practitioner groups with powers, and those groups developed and implemented public policy objectives. Their rules were backed by legal sanctions. This arrangement drew criticism for being bureaucratic and unwieldy, whilst still being susceptible to regulatory capture and not protecting consumers well enough.

2.7 Prior to 1997, the banking sector was supervised by the Bank of England. Until the introduction of the Banking Act in 1987 the Bank of England ran a two-tier regulatory system. It exercised greater power over 'secondary', or deposit-taking, banks than it did over 'primary', or clearing, banks. The reforms of 1987 abolished this system and established a more consistent approach.

2.8 Prior to 1997 a succession of monetary and fiscal policy frameworks sought to provide macroeconomic stability and prosperity, with varying degrees of success. Price stability was often undermined by a relative lack of credibility in Government targets, partly because the Chancellor remained in control of monetary policy levers. Policy decisions sometimes appeared to be driven by short-term considerations and were often not transparent. Past monetary policy regimes which sought to target monetary aggregates and the exchange rate, rather than price stability itself, also led to increased output volatility.

2.9 Prior to 1997 fiscal policy often contributed to price and output instability. Fiscal policy interventions were often not co-ordinated well with monetary policy. Fiscal policy was not set within a medium-term rules-based framework providing transparency and accountability.

3. Institutional Reform Post-1997

Strong institutional arrangements

3.1 One important element in building sound institutions is to avoid conflicts of interest, or the risk of them. Where one aspect of policy has to be compromised in order to meet another policy objective, credibility will be lost. Experience shows that it is better for monetary policy, fiscal policy, debt management and financial regulation to have separately identified objectives, with responsibility for achieving them clearly attributable to one institution. Ideally, it would be preferable to identify a separate institution for each policy objective. In the UK, for example, the Bank of England has been given a clear responsibility for operating monetary policy, the Financial Services Authority has responsibility for financial services regulation, and the Debt Management Office has operational responsibility for carrying out the Government's debt management policy. Giving institutions a single objective can help improve performance, because the institution can then focus its efforts more directly. It can also enhance accountability, because it is easier to judge whether or not the objective has been met.

3.2 The UK's institutional reforms were introduced against this background of weak monetary and fiscal policy and the increasing ineffectiveness of financial regulation. The ultimate aim was to improve employment opportunities and living standards. The link between low and stable inflation and improved employment and economic growth had been well-established by economists. Reforms to the monetary and fiscal policy frameworks were directed towards achieving such low and stable inflation.

3.3 Effective financial regulation combined with an effective financial stability framework is also required to maintain market and consumer confidence, safeguard consumer welfare, and maximise the efficiencies and potential benefits of liberalisation and globalisation.

Monetary and Fiscal Policy Reform

3.4 A new macroeconomic policy framework was established in 1997 with the aim of raising the sustainable rate of economic growth and achieving rising prosperity by creating economic and employment opportunities for all.

3.5 The key elements of these reforms were the transfer of operational responsibility for monetary policy to the Bank of England, and the creation of a new fiscal policy framework founded on two key rules:

- The 'golden rule', which states that over the economic cycle the Government will borrow only to invest and not to fund current spending, and;

- The sustainable investment rule, which states that public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

3.6 These reforms created clear long-term policy objectives and increased openness and transparency. They generated the credible pre-commitment to an inflation target which had been lacking before.

3.7 These reforms have been explained in detail in a separate paper submitted to the G20[2] and are not discussed in detail here. The interdependencies between reforms to monetary and fiscal policy and reforms to financial regulation are worth noting, however. Pursuing one without the other would compromise realising the benefits of both. Without a strong, flexible and accountable supervisory structure, the threat of systemic crises in the financial sector would undermine the positive effects of price stability and long-term policy predictability.

Regulatory Reform

Rationale for a Unified Regulator

3.8 Financial markets have become increasingly globalised. Over the past two decades many new and sophisticated financial products have been developed, and financial conglomerates have emerged. In response there has been a movement towards consolidated institutional structures for financial regulation in a number of countries. Banking, insurance and securities supervision were combined in Denmark in 1988 and in Norway in 1986[3]. Sweden established a unified regulator in 1991.

3.9 Although there is broad international consensus on the pressures driving change, opinion is more polarised on which institutional model is best at addressing them. The arguments for a unified institutional structure are:

- **Economies of scale** – a single regulator should be more efficient because of shared resources and the ability to exploit synergies between different areas of regulation.
- **Simplicity** – a simple regulatory structure should be understood and recognised by firms and consumers more easily.
- **Structure mirrors market reality** – with the increasing complexity of financial markets and the rise of financial conglomerates, the traditional functional divisions that were reflected in regulatory structures are no longer so relevant. A single regulator avoids the need for a conglomerate to deal with numerous supervisors, and for numerous supervisors to work well together to achieve an overview of one firm.

[2] 'Macroeconomic Frameworks in the New Global Economy', HM Treasury, Nov. 2002 (http://www.hm-treasury.gov.uk/media/B6356/admacro02-249kb.pdf).

[3] 'The Rationale for a Single National Financial Services Regulator', Clive Briault, FSA Occasional Paper No.2, May 1999.

- **Prevention of regulatory arbitrage** – a single regulator should avoid problems of regulatory arbitrage, inconsistencies and duplication.
- **Accountability** – this should be clearer with a simple structure. It is more difficult for a single agency to avoid taking responsibility.
- **Reduced costs** – the compliance costs imposed on regulated firms should be reduced as they only need to deal with one agency.
- **Improved policy coordination** – especially when responding to a crisis.

3.10 Nevertheless, it is important to tailor the organisational and legal framework to avoid potential pitfalls[4]:

- There remain differences between banks, securities firms and insurance companies in the type of business they perform and the nature of risks they pose to financial stability and to consumer protection. This has implications for the extent of efficiency gains anticipated;
- The organisational complexity of a unified regulator may have implications for the extent of its improved effectiveness;
- There may be potential for moral hazard arising from public perceptions that a risk spectrum amongst financial institutions has disappeared as separate regulatory authorities no longer exist;
- A unified regulator might run the risk of becoming too powerful and drifting towards over-regulation unless subject to effective accountability arrangements.

The UK Model – Financial Services Authority (FSA)

3.11 In 1997 the Government inherited a complex and fragmented structure of regulation[5]. There were separate prudential regulators for banks (the Bank of England), insurance companies (the Department for Trade and Industry[6]) and building societies. It was a system that was described by the Chancellor Gordon Brown as being, "...costly, inefficient and confusing for both regulated firms and their customers", and which was "...not

[4] 'Financial Regulation: Why, How and Where Now?', Goodhart et al., London & NY., 1998, Routledge.

[5] There were nine separate successor agencies regulating the same area that the FSA now regulates. These were; Investment Management Regulatory Organisation; Personal Investment Authority; Securities and Futures Authority; HM Treasury (Insurance); Bank of England (Banking supervision); Securities and Investments Board; Building Societies Commission; Friendly Societies Commission; Registry of Friendly Societies (credit unions).

[6] Responsibility for insurance supervision was moved from the Department for Trade and Industry to HM Treasury in 1999, and then to the FSA shortly afterwards.

delivering a standard of supervision and investor protection that the public has a right to expect.[7]"

3.12 The regulatory structure no longer fitted the financial sector well. The blurring of boundaries between different types of institution was pronounced. Cross-sector mergers and acquisitions and the expansion of firms into new areas led to the emergence of many financial conglomerates. There had also been a blurring in financial product structure and design. These developments meant that the UK financial sector was best suited to the single regulator model.

Structure of the Financial Services Authority – Constrained discretion

3.13 In the world of global capital markets the new UK macroeconomic framework is based on a 'Constrained Discretion' model. This new model recognises that in an open economy, rigid rules do not produce reliable targets for achieving long-term stability. Instead, the *discretion* necessary for effective economic policy - short-term flexibility to meet credible long-term goals - is possible only within an institutional framework that commands market credibility and public trust with the government *constrained* to deliver clearly defined long-term policy objectives and maximum openness and transparency.

3.14 This approach to policy making enhances credibility, and therefore the effectiveness of policy, by ensuring the objectives of policy are clear and the way in which those objectives are pursued is clear. The key principles for a framework of credible 'constrained discretion' are:

- Clear and sound long-term policy objectives;
- Pre-commitment, through institutional arrangements and procedural rules; and
- Maximum openness and transparency and clear accountability.

3.15 In monetary policy this model was applied by giving operational independence to the Bank of England in 1997. There is a clear division of responsibilities between government and the central bank so that the elected government sets the wider economic strategy and within that the objectives for monetary policy, the inflation target, while monthly decisions to meet that target is passed over to the central bank, thereby removing tactical decisions on interest rates from the political process. The

[7] 'The Rationale for a Single National Financial Services Regulator', Clive Briault, FSA Occasional Paper No.2, May 1999.

Government and Bank are constrained by pre-committing to long-term stability of the target but the Bank is granted discretion to respond flexibly to changing economic conditions.

3.16 Similarly for financial service regulation, this model was applied to the formation of the FSA. The Government**,** through the Treasury, retains responsibility for the overall institutional structure of financial services regulation and for the legislation which governs it. It sets the FSA's long-term policy objectives. However the FSA has operational responsibility for delivering these objectives and is accountable for doing so within a framework that maximises the transparency of the process.

3.17 Four key principles defined the shape of the new regulatory regime for financial services in the UK:

- There should be a single organisation responsible for the regulation of financial services;
- There should be a single statute setting out the framework under which the regulator operates;
- The regulator should be operationally independent from the monetary authority and the Government;
- There should be a tripartite arrangement for financial stability issues setting out the respective responsibilities of the regulator (FSA), central bank (Bank of England) and the finance ministry (HM Treasury).

Financial Services and Markets Act (2000)

3.18 The FSA acquired its responsibilities in two stages. First the Bank of England Act 1998 transferred responsibility for the supervision of banks and money-market institutions from the Bank of England to the FSA. The FSA was constituted as a private company, independent of Government, and funded through a levy on the firms that it regulates.

3.19 The second stage involved the creation of a new statutory regime under which the FSA operated, the Financial Services and Markets Act (2000) (FSMA). This came into force on 30th November 2001.

3.20 FSMA consolidated responsibility for financial regulation under the FSA and conferred broad new statutory powers to carry out these responsibilities. Statutory regulation replaced self–regulatory arrangements. FSMA re-oriented the UK’s approach to regulation through its statutory objectives and principles of good regulation.

3.21 Four statutory objectives define the role and functions of the FSA:

- Maintaining market confidence in the financial system;
- Promoting public awareness and understanding of the financial system;
- Securing the appropriate degree of protection for consumers, while having regard to the general principle that consumers should take responsibility for their decisions;
- Reducing the extent to which it is possible for a business carried on by a regulated person or body to be used for a purpose connected with financial crime, such as money laundering, fraud and insider dealing.

3.22 In pursuing these objectives FSMA requires the FSA to have regard to seven principles of good regulation:

Principle 1: Regulatory resources should be used in the most efficient and economic way.

Principle 2: Supervision, however effective, should not replace sound management in a firm – encouraging good corporate governance is crucial.

Principle 3: The costs to a regulated body should be proportionate to the benefits of regulation.

3.23 The last four principles are inter-linked and give prominence to competitiveness issues, reflecting the concern that regulation should not unnecessarily obstruct or distort competition and innovation.

Principle 4: Innovation in connection with regulated activities should be facilitated.

Principle 5: The international character of financial services and markets should be considered alongside maintaining the competitive position of the United Kingdom.

Principle 6: The adverse effects on competition that may arise from regulation should be minimised.

Principle 7: Competition should be facilitated between those who are subject to regulation.

3.24 Prior to FSMA the desired outcomes of financial sector regulation were not defined in transparent terms. In creating a set of statutory objectives, FSMA created a foundation upon which the organisational structure of the FSA could be built, and against which regulatory performance could be judged.

3.25 The distinction between the four statutory objectives and seven principles might seem innocuous, but is important. Whilst the objectives are statutory, principles need only be 'taken into account', therefore establishing a sense of priority.

3.26 The relationship between the objectives and principles can have important implications in practice. For example the FSA does not aim to implement a zero-failure regime in order to preserve market confidence[8]. Such a regime would be excessively burdensome for firms and may stifle innovation and competition. These are both key elements of the principles of good regulation which should inform FSA behaviour.

3.27 The FSA is a private company which discharges a public function and has regulatory powers conferred upon it by statute. The FSA is not reliant upon central government for its funding, but has the power to levy fees on all the firms which it regulates to cover the costs of its functions as defined within FSMA. The FSA reports annually on its planned expenditure and is statutorily required to consult on its proposed fee structure.

3.28 FSMA did not widen the scope of the FSA in any significant way beyond those activities and products already regulated. These broadly encompassed activities and products related to savings, investments, deposit-taking and insurance. Regulating the listing of shares initially remained with the London Stock Exchange but was transferred to the FSA in May 2000. The FSA's remit will be extended with the addition of regulation of mortgages and long term care insurance in October 2004 and of general insurance mediation in January 2005.

3.29 FSMA confers on the FSA wide powers to create and enforce rules. Whilst the boundaries of regulation are determined by statutory instrument subject to Parliamentary scrutiny, the FSA can create detailed rules without reference to Parliament. The FSA's rules impose binding requirements on authorised persons and have the force of law.

3.30 The FSA's powers are limited by a series of mechanisms designed to make the FSA accountable, transparent and proportionate in its actions.

---

[8] 'A New Regulator for the New Millennium', FSA, Jan 2000, (www.fsa.gov.uk/pubs/policy/p29.pdf).

Accountability of the FSA

3.31 Under FSMA there are a number of mechanisms under which the FSA is held accountable, primarily to Treasury Ministers, but also to Parliament and the wider public. These mechanisms can be broadly broken down into three different groups:
- Accountability of the FSA as an organisation;
- Accountability of FSA rule-making;
- Accoutability of FSA decisions.

(i) Accountability of the FSA as an organisation

3.32 The FSA must explain what progress it has made against its statutory objectives and principles of good regulation via an annual report to the Treasury. The content of the annual report is decided in conjunction with the Treasury and the final document is laid before Parliament and published.

3.33 Under the terms of FSMA the Treasury is able to initiate independent performance reviews of the FSA. The Board of the FSA must include a majority (currently 11) of non-executive directors, who are required to report on the efficiency of the use of FSA resources and to ensure that the 4 executive members of the board discharge their duties correctly. The board is appointed, and may be dismissed by, the Treasury.

3.34 Two statutory panels are established under FSMA, the Financial Services Practitioner Panel and the Consumer Panel. Both bodies are independent of the FSA and may make representations directly to the FSA Board. The FSA is obliged by FSMA to have regard to the recommendations of the Panels. Where the FSA disagrees with Panel representations the FSA must provide reasons for its disagreement. The FSA's responses to Panel recommendations are included in the FSA's annual report.

3.35 FSMA also established an independent Complaints Commissioner, who investigates complaints against the FSA's exercise of its functions. These might include complaints about maladministration, negligence, unreasonable delay, unprofessional behaviour, bias and lack of integrity.

(ii) Accountability of FSA rule-making

3.36 Under FSMA the FSA has rule-making powers and power over the preparation and issuing of codes such as the FSA's Code of Market Conduct. The FSA is able to give general guidance and to determine general policies. All of these are collectively termed

FSA legislation. Accountability in setting FSA legislation is ensured through requirements for broad consultation before its introduction.

3.37 In exercising its legislative functions, the FSA must act in a way that is compatible with its four statutory objectives. In addition the FSA may make rules if they appear to be necessary or expedient for the purpose of meeting its objectives. If the FSA proposes to make any rules it must publicly consult on them, and the consultation must be accompanied by, amongst other things, a cost-benefit analysis and an explanation of the FSA's reasons for believing that making the proposed rules is compatible with its statutory objectives and principles of good regulation.

(iii) Accountability of FSA decisions

3.38 The FSA is accountable for the decisions it makes under its rules through a number of routes. A party aggrieved by a FSA decision or exercise of a disciplinary power may refer the matter to the Financial Services and Markets Tribunal, which is an independent statutory body. The Practitioner and the Consumer Panels mentioned above are able to demand written disclosures from the FSA explaining particular actions and decisions.

3.39 In addition there are a number of external independent bodies that may hold the FSA to account, including the Director of the Office of Fair Trading, who is able to review FSA regulations and recommend change where they might have an anti-competitive impact. The existence of an independent Complaints Commissioner and the Financial Services and Markets Tribunal, both set up by FSMA, guarantee a neutral route of redress.

Risk-Based Supervision

3.40 One guiding principle which shapes the operation of the FSA is that similar risks should be regulated in the same way regardless of the type of institution regulated. Under FSMA, the FSA has introduced a single enforcement regime applicable to all the firms and individuals that it regulates. The FSA has also developed an authorisation process that applies across all sectors. Likewise conduct-of-business rules have been developed that apply across all regulated firms.

3.41 The FSA has developed a risk-focussed framework to set supervisory priorities and allocate resources. This allows the FSA to focus regulatory resources where the greatest risks to financial stability lie. Potential risks for the coming year are identified by the FSA in their Financial Risk Outlook, published in every January[9].

Independence from the Monetary Authority

3.42 An important characteristic of the UK's financial sector regulatory regime is that it remains independent of the monetary authority (i.e. the Bank of England).

3.43 Supervision of the banking sector by the central bank carries the risk that problems with banking supervision can impair the central bank's reputation. This may harm the credibility of monetary policy if this is a central bank responsibility.

3.44 Conversely, monetary policy may be used to provide financial assistance to the banking sector, and weak regulation can leave the banking sector vulnerable financially. Monetary policy may therefore be used to mask the effects of weak banking regulation. This possibility can damage the credibility of monetary policy unless responsibility for monetary policy is split from that for banking supervision.

3.45 This separation in the UK has enhanced the credibility of both the FSA and the Bank of England as it has removed any potential for conflicting interests to distort policy decisions.

Tripartite Stability Framework

3.46 Having enhanced fiscal, monetary and regulatory credibility through clarifying objectives and responsibilities, the UK system was potentially vulnerable to policy coordination failures between the three institutions, especially with regard to systemic crisis management. To address this risk, the UK authorities established a mechanism for coordination and communication between the three parties. Details of this tripartite stability framework are set out in a Memorandum of Understanding (MoU) agreed in 1997 by the Bank of England, HM Treasury and the FSA.

3.47 This MoU sets out clearly the role of each institution and how they work alongside each other to deliver the key objective of financial stability. The division of responsibility between the three institutions responsible for financial stability is based upon four principles:

[9] The FSA's Financial Risk Outlook for 2003 is available from the FSA's website (http://www.fsa.gov.uk/pubs/plan/financial_risk_outlook_2003.pdf).

- Accountability - each institution must be accountable for its actions, so each must have unambiguous and well-defined responsibilities;
- Transparency - Parliament, the markets and the public must know who is responsible for what;
- No duplication - each institution must have a clearly defined role, to avoid second-guessing and duplication. This will help ensure proper accountability;
- Regular information exchange to aid each institution in the discharge of its responsibilities as efficiently and effectively as possible.

3.48 The **Bank of England** is responsible for monitoring the stability of the monetary system, developing and improving financial system infrastructure to help reduce systemic risk (by promoting improvements, for example, in payments and settlements systems, regulation and accounting), and for taking a broad overview of the financial system as a whole. The Bank of England's surveillance is published semi-annually in the Financial Stability Review.

3.49 The logic for allocating these responsibilities to the Bank of England was that it was uniquely placed at the heart of the UK's monetary and payments systems and therefore best positioned to spot any potential problems and threats to financial stability.

3.50 The MoU confirms that responsibility for day–to-day supervision of the financial sector and for the conduct of regulatory policy rests with the **FSA**. The FSA's core responsibilities in the MoU are described as:

- The authorisation and prudential supervision of banks, building societies, investment firms, insurance companies and friendly societies;

- The supervision of financial market and clearing and settlement systems;

- The conduct of operations in response to problems affecting firms and;

- Regulatory policy in all of these areas.

3.51 Following the model of constrained discretion, under the terms of the MoU, the **Treasury** retains responsibility for the overall institutional structure of financial services regulation and for the legislation which governs it. The Treasury does not have any operational responsibility for the activities of the Bank of England and the FSA.

3.52 Cooperation and the exchange of information between all three parties was established through the creation of a Financial Stability Standing Committee consisting of representatives from the Bank of England, FSA and Treasury. The Standing Committee has now met upwards of 60 times to discuss issues such as the threat posed to UK financial services by a terrorist attack; the implications of geopolitical issues; the effect of downturns in equity markets; and firm-specific problems such as those that might have arisen from the collapse of the LTCM hedge fund. This forum for proactive cooperation amongst the key parties concerned with financial stability has strengthened the ability of the UK authorities to monitor and maintain financial stability.

3.53 An essential part of the success of this framework has been the existence of single unified body in the shape of the FSA. Before 1998 it would have been a major challenge to get the nine separate banking, securities and insurance regulators to work closely together in this context.

Complementary second-level institutional reforms

3.54 These major institutional reforms to financial services regulation and financial stability impacted on complementary institutional frameworks, in particular those relating to the management of UK government debt and to payments and settlement systems.

Debt Management Office (DMO)

3.55 As part of the reforms to the macroeconomic framework announced by the Chancellor of the Exchequer in 1997, the Government transferred responsibility for debt management from the Bank of England to HM Treasury. In April 1998, the UK Debt Management Office (DMO) was created as an executive agency of HM Treasury, accountable to Treasury Ministers. In another application of the constrained discretion model, Treasury Ministers set the objectives and approve the annual financing remit given to the DMO and the agency then exercises discretion within-year to meet those objectives.

3.56 The decision to establish the DMO as an executive agency ensured that it did not have advance access to information on Government and other policy decisions nor to information published by the Office for National Statistics (except in relation to the Government's financing needs). This removed any perception that inside information, particularly on monetary policy, might influence debt management policy.

3.57 Establishing the DMO avoided possible conflicts of interest between debt management and monetary policy decisions, which could undermine the objective of minimising the cost of Government financing and of cash management. This objective is achieved through pursuing an issuance policy that is open, transparent and predictable. In addition, the transparency of monetary policy is increased by the sterling markets not reading signals about the future course of official interest rates into operational debt management decisions.

3.58 The DMO assumed responsibility for the government's cash management in the Spring of 2000. By ensuring that the Treasury is responsible for the management of the Government's cashflows, this move has ensured that the UK Government has increased its efforts to improve the accuracy of its cashflow predictions and optimise the efficiency of those flows.

3.59 The UK's debt management practices are fully in line with the IMF and World Bank Guidelines for Public Debt Management. Due to the low level of UK Government indebtedness and the Government's prudent approach to managing risks in the UK, the management of public debt is not a source of vulnerability for the financial system[10].

Payments and Settlement Systems

3.60 The payments system infrastructure underpins that of the overall financial system. Oversight of the payments system is a key element of the Bank of England's responsibility for the stability of the financial system as a whole[11]. Payments system oversight is based upon the ten 'Core Principles'[12] developed by the Committee on Payment and Settlement Systems (CPSS). These principles cover legal soundness, financial and settlement risk, security and operational reliability, efficiency, access rules and governance.

3.61 The UK's main high value payment system is CHAPS (Clearing House Automated Payment System). Though CHAPS complies fully with the ten 'Core Principles', there have been moves to

[10] United Kingdom: Financial System Stability Assessment including Reports on the Observance of Standards and Codes, March 3, 2003, (www.imf.org/external/np/fsap).
[11] The Bank's role is described in 'Oversight of Payment Systems', Bank of England, November 2000.
[12] 'Core Principles for Systemically Important Payment Systems', Bank for International Settlements, January 2001 (www.bis.org).

improve the system's governance and risk management framework. Retail payment services such as direct debits, standing orders and salaries are provided by BACS (Bankers' Automated Clearing System). Other retail payment mechanisms are provided by Cheque and Credit Clearing, debit and credit cards and LINK Interchange Network Ltd[13]. The Bank of England has been encouraging improvements in these bodies' risk management systems.

3.62 The UK's payment clearing systems have developed through the actions of commercial institutions and are not, in the main, the subject of specific legislation or regulatory provisions. The most widely used clearings in value terms are owned and controlled by their members through the clearing companies under the Association for Payment Clearing Services (APACS). APACS has recently changed its governance structure to separate responsibility for clearing services (such as the operation of CHAPS) from APACS' industry-wide activities, and has launched a project to determine explicit default rules for BACS.

3.63 Both as a member of the larger systems and through its oversight of payments systems, the Bank has supported these market-led developments to reduce risk and improve efficiency.

3.64 Securities clearing and settlement systems are supervised by the FSA as Recognised Clearing Houses (RCHs). In the UK there are two RCHs, the London Clearing House and CREST. CREST is now part of the Euroclear group and settles equities, corporate bonds, gilts and money market instruments. A bilateral Memorandum of Understanding (MoU) has recently been signed between the FSA, Bank of England and Belgian authorities on the regulation and oversight of the enlarged Euroclear group. This MoU governs cooperation and information sharing between the relevant authorities and is consistent with the CPSS 'Core Principles'.

3.65 The principle followed throughout the UK payments systems architecture has been for oversight rather than regulation. Institutional developments have been market-led rather than driven by legislative or policy changes. The Bank of England plays an important role in encouraging the reforms outlined above and in maintaining rigorous oversight of payments systems.

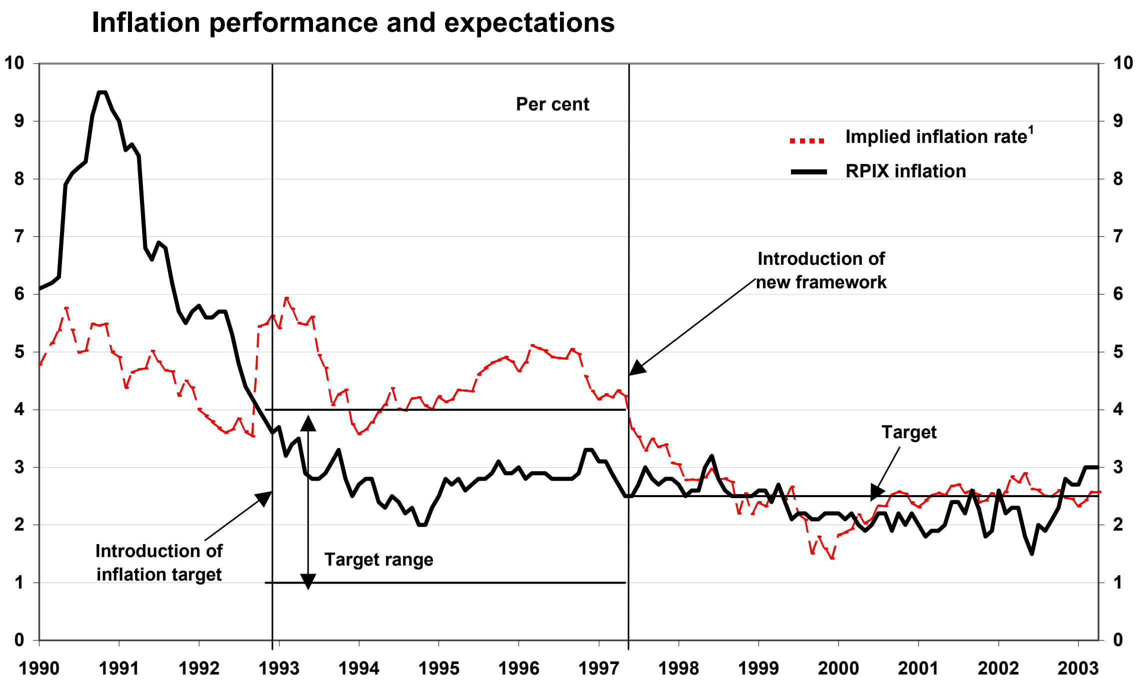
[13] LINK Interchange Limited is a transaction management company that manages the UK's only independently branded Automated Teller Machine network.

Impact of financial sector institution building

3.66 The purpose of developing a new institutional framework for regulating the financial services sector was to support ongoing financial stability, a prerequisite for sustained economic growth. The ultimate ends of the UK's monetary and fiscal policy frameworks are also to improve economic growth and increase employment.

3.67 The changes to the UK's monetary and fiscal policy frameworks have had a positive impact on macroeconomic stability. Inflation has been markedly more stable since 1997, and has remained much closer to expectations than had previously been the case (see Chart 1 below). Despite a period of global uncertainty, the UK has continued to grow and is experiencing the longest unbroken economic expansion on record[14].

Chart 1.



[1] Ten year ahead market inflation expectations

3.68 The IMF's financial stability indicators show that UK banks remain well-capitalised and profitable despite recent falls in equity markets, and that they have relatively low rates of non-performing loans[15]. The results of stress tests developed by the IMF, in conjunction with the UK authorities as part of the IMF's

[14] The UK has now experienced 43 consecutive quarters of positive GDP growth.
[15] Bank of England's Financial Stability Review (June 2003).

Financial Stability Assessment Programme[16], indicate that the stability of UK banks should not be compromised under the scenarios tested. UK banks should remain profitable in the face of relatively large shocks. This led the IMF to conclude that, "UK banks appear to be sufficiently profitable and well-capitalised overall to be able to absorb, without systemic distress, the losses that might arise if…potential risks…were to crystallise."[17]

3.69 Whilst the robustness of the financial sector reflects in part a sound and credible monetary policy regime, financial stability remains a crucial factor in sustaining macroeconomic stability and hence the conduct of that monetary policy. The robustness of the UK financial sector cannot be explained by the introduction of macroeconomic policy frameworks alone. It also owes much to the structure and nature of financial services regulation in the UK; proportionate, objectives driven and risk-focussed.

IMF Financial Stability Assessment Programme

3.70 The reports published under the IMF's Financial Stability Assessment Program (FSAP) provide a rigorous and objective view of the UK's regulatory framework.

3.71 The FSAP is a joint IMF and World Bank programme. Supported by experts from a range of national agencies and standard-setting bodies, the programme seeks to identify the strengths and vulnerabilities of a country's financial system; to determine how key sources of risk are being managed; to ascertain the sector's developmental and technical assistance needs; and to help prioritise policy responses. This exercise provides useful benchmarks and examples of best practice, and was something the UK was keen to engage with.

3.72 As part of the FSAP the UK recently received a Financial System Stability Assessment (FSSA) from the IMF. This provided an analysis of the strengths and areas for development of the current system. The IMF's overall assessment of the UK's regulatory reforms was positive. The FSSA summary stated that:

> "The [UK's] financial sector is supported by a financial policy framework that has been significantly strengthened in a number of ways in recent years, and that in many respects is at the forefront internationally…. Supervision in the UK is in turn supported by a well-functioning safety net, systemic liquidity,

[16] See below for more details on this programme.
[17] IMF Financial System Stability Assessment for the UK, March 2003.

system-level surveillance, and insolvency arrangements and a high quality accounting and disclosure regime."[18]

3.73 The FSSA highlighted the importance of the coordination between key players in the tripartite stability framework, as set out in the Memorandum of Understanding (MoU) between the FSA, Bank of England and the Treasury and the associated Financial Stability Standing Committee. The FSSA also made note of the overall coherence of the UK regulatory structure and its adherence to principles of clarity and accountability.

3.74 The surveillance and monitoring work carried out by the Bank of England and the FSA was acknowledged to be of a high quality. The overall quality and effectiveness of the supervision carried out by the FSA was endorsed in particular in the banking and securities sectors. Further work was identified for the insurance sector. The UK's payments and settlements systems were seen to have made good progress over recent years.

3.75 An important element of the FSSA was the completion of a Report on the Observance of Standards and Codes (ROSC). ROSCs monitor the extent to which countries observe international standards and codes. These standards and codes are an important component of financial stability in an increasingly globalised and inter-dependent world and are relevant for all countries.

3.76 Reflecting the importance that the UK attaches to the ROSCs, the UK was assessed as part of the FSSA against a range of codes and standards modules, including 'Banking Supervision', 'Securities Market Regulation' and 'Insurance Regulation'. The UK was the first country to be assessed against the new code on 'Money Laundering and Combating Terrorist Financing', and stands ready to be assessed against modules on 'Corporate Governance', 'Auditing' and 'Insolvency and Creditor Rights'.

3.77 The UK's experience of the FSAP was very positive. Good practice was highlighted and useful pointers were provided on where future efforts need to be focused. The UK would encourage other states to engage in this process, not only because of the benefits that accrue to each individually, but also because of the positive effects for global financial stability from sharing best practice and improving regulatory cooperation between nations.

[18] United Kingdom: Financial System Stability Assessment including Reports on the Observance of Standards and Codes, March 3, 2003 (www.imf.org/external/np/fsap).

Performance of the FSA

3.78 In assessing the effectiveness of institutional reforms the performance of the FSA against its statutory objectives should also be considered.

- **Maintenance of Market Confidence** - The FSA has from the outset focussed on the maintenance of market confidence as something which is fundamental to the successful operation of the financial system as a whole and of the wider economy. Reports from the Financial Services Practitioner Panel indicate that market confidence has remained high, and the presence of a strong regulator with cross-sectoral reach has been welcomed by the vast majority of practitioners in the UK. The benefits of regulation have generally been felt to outweigh the costs, with regulation being proportionate.

- **Promoting Public Awareness** - The FSA under FSMA is designed to balance the views of both consumers and practitioners in the creation and implementation of regulation. Education of consumers is an important pre-requisite for allowing the regulator to strike the correct balance between consumers and providers, as well as helping to build consumer confidence in the financial sector. To date the FSA's education initiative has worked well, and the FSA is looking to build on this in future, alongside extending work on improving consumers' understanding of financial services.

- **Protecting Consumers** – The regulatory regime does not aim to protect consumers from all risks to their investments, and one of the key challenges for the FSA has been to explain the limitations of the consumer protection regime. Progress made by the FSA against this objective has largely been through the successful implementation of the broader regulatory framework.

- **Reducing Financial Crime** – The FSA has worked in conjunction with HM Treasury and UK law enforcement authorities to push forward implementation of the FATF 40 Recommendations for Anti-Money Laundering and the 8 Special Recommendations for Combating the Financing of Terrorism. In the past year the FSA's work on anti-money laundering has focused on gaining an improved understanding of the scale and distribution of risk and raising industry standards. The FSA has worked closely with the UK Home Office, the National Crime Intelligence Service (NCIS) and industry to ensure the smooth implementation of the Proceeds of Crime Act 2002.

4. Future Reforms

4.1 The UK authorities have identified a number of areas for further reform. Some parts of the framework need to be developed to assimilate changes to international agreements and standards. The FSSA usefully highlighted areas where further reform would be desirable.

Insurance Supervision

4.2 The FSA was designed to establish a common risk-based approach to regulation across all financial sectors. To date the operation of the FSA has highlighted the differences which remain between the regulation of insurance and other sectors in respect of similar types of risk. This disparity was also identified by the FSSA, and a recommendation was made that further work be carried out to provide the UK with the insurance regulation that its status as a major international centre demands.

4.3 Work has been initiated by the FSA to implement the recommendations of the Tiner Report on the Future Regulation of Insurance[19], which set out measures for reforming the regulation of insurance in the UK. Key recommendations in that report included improvements in the disclosure regime, changes to the capital requirements for insurance companies, and the implementation of a risk-based approach to regulation in the insurance sector.

4.4 Implementing the recommendations of the Tiner Report should lead to improved transparency of early intervention actions, stronger reporting and disclosure, and improved governance requirements. These actions should address the potential weaknesses identified by the IMF FSSA.

EU and Global Developments

4.5 The nature of global markets means that financial regulatory institutions need to work across borders. Many of the reforms which should be implemented in the UK in the near future are related to developments and agreements at the European and international level. Examples are the proposed Basel II Capital Adequacy revisions, the EU Risk-Based Capital Directive, Solvency II Directive, and Reinsurance Directive.

[19] 'The Future Regulation of Insurance', Report submitted by the Board of the FSA to the Economic Secretary of the Treasury, Dec. 2001 (www.fsa.gov.uk/pubs/other/future-reg_insurance.pdf).

4.6 The ability of the UK regime to react in a coordinated manner to proposals for improved standards arising from international requirements has been enhanced under the framework of the MoU, given the Bank of England's focus on developing the infrastructure to reduce systemic risk and the FSA's establishment as a single regulator.

4.7 The Bank of England and FSA have been working since 1998 with other authorities responsible for banking supervision on the revision of the Basel Capital Accord. Aligning capital adequacy for credit and operational risk more closely with the risks to which banks are exposed is something that the FSA is well-prepared to meet. The FSA also participates in the range of bodies working to strengthen the global financial architecture (such as IOSCO (securities), IAIS (insurance) and the Financial Stability Forum).

4.8 The UK's relationships with other EU states is of great importance in shaping the nature of further reform. The UK has been at the forefront in encouraging improved coordination and cooperation amongst EU regulators and legislators in the drive to complete the EU's single market in financial services.

4.9 In encouraging cooperation and coordination the UK also recognises the importance of diversity in national regulatory regimes. A successful institutional model in one country may not be suitable for another. The UK regime is founded on broad principles of good regulation, which are implemented via an institutional structure tailored to fit the nature of the UK's financial sector. It is these principles that we hope to build upon with our EU and international partners.

5. Conclusions

5.1 Financial stability is an essential prerequisite for realising the potential benefits of liberalised financial markets. In order to achieve that stability it is necessary to have a clear and credible policy framework which facilitates cooperation and communication between key players (central bank, finance ministry and financial services regulator where separate). It is also, of course, crucial importance to have a regulatory structure which provides effective and efficient regulation.

5.2 The critical elements of the UK's reform process in the field of financial regulation were the separation of banking supervision from the operation of monetary policy; the creation of a single regulator that covers banking, securities and insurance; the establishment of a framework within which the regulator is independent from, but accountable to, Government in the pursuit of its statutory objectives; and a tripartite arrangement whereby the finance ministry, the monetary authority and the financial regulator meet regularly to discuss issues affecting the stability of the domestic and global financial system.

5.3 Much of what the UK has learned from its experience of institutional reform in the financial sector relates specifically to the UK context. However, some more general lessons can be drawn from the UK's reforms:

- In the context of ever more globalised financial markets there are increasingly acute threats to financial stability. Hence the need for a comprehensive and effective stability framework becomes increasingly important. The institutional structure chosen to implement that financial stability framework will have a crucial impact on the efficiency of the framework.

- There are dependencies and synergies between reforms aimed at producing macroeconomic stability and financial stability. It is important to conceive of reform as part of a broad strategy rather than a piecemeal response to crises.

- The UK has found that the model of 'constrained discretion' has had a number of fruitful applications (financial regulation, fiscal policy, debt management) beyond the more familiar field of monetary policy.

- The key principles in applying the framework are clarity, transparency and accountability, which combine to deliver the credibility which underpins stability.

- Reform is not a one-off event, but an ongoing process constantly to develop and improve the institutional structures which support financial stability.

5.4 The use of an objective assessment tool such as the IMF FSAP is very helpful in identifying strengths and areas for development. It is also an important way of creating benchmarks against which future performance can be measured, and facilitates the sharing of best practice between different states. Wider engagement by all countries with the FSAP and corollary ROSCs programme is something which the UK would recommend.