

Defining the Public Interest: Public Law Perspectives on Regulating the Financial Crisis

A Public Law analysis of the future
of financial regulation by the FSA
in the light of the Turner Review

Outline and summary

- Introduction;
- Banking regulation in an historical context;
JMB and BCCI; The system of Tripartite Regulation : Financial Services and Markets Act 2000 and principles based regulation;
- Principles-based regulation in the Post Northern Rock era;
- Protecting the Public Interest: The Way Forward and Conclusions.

- “But in exact proportion to the power of this system is its delicacy- I should hardly say too much if I said its danger”

W. Bagehot (1870)

Introduction

- The recent Turner Review (2009), the findings of the Treasury Committee's review of the failures at Northern Rock and the FSA's own internal review point to regulatory failures.
- In an historical context what are “principles based” regulation and how has UK systems of regulation developed ? What are the lessons from Northern Rock and what is the future of regulation ?
- Two proposals for protecting the public interest and ensuring greater accountability- post legislative scrutiny of all Banking legislation and the creation of a Standing Select Committee.

Banking Regulation in an historical context

- Bank of England- the Bank Charter Act 1844;
- The Radcliffe Report (1959);
- 1979 and abolition of exchange controls;
- Banking Act 1979 and Bank of England regulation;
- Johnson Mathey Bankers (JMB);

JMB and Leigh Pemberton Committee (1985)

- Nigel Lawson- the Bank of England decided to rescue JMB with an input of 50% of £150 million;
- “... Yet no-one had seen fit to mention it to me.... The Bank of England had been working night and day to try and discover the facts, evaluate the situation and effect a rescue; still without a single word to me”. Nigel Lawson on the collapse of JMB.

BCCI and the Bingham Report

- Banking Act 1987 – a Board of Banking Supervision with independent members;
- Bank of Credit and Commerce International (BCCI) Lord Bingham's Report (1992) concluded;
- Concerns about BCCI were not acted upon;
- Bank of England feared that intervention might cause instability in the banking system;
- Lapses in BCCI's management and fraud were not followed up;
- Bank of England claimed it had insufficient legal powers when in fact in all probability it did.

The Financial Services Authority

- Financial Services and Markets Act 2000
- Tripartite arrangements:
- FSA main regulator – authorisation and supervision of firms providing financial services;
- Supervision of financial markets;
- Continual conduct supervision in response to firms, markets and clearing banks.

Principles based regulation: assumptions

- Markets are self correcting;
- Primary management of risks is with management and boards of individual firms;
- Customer protection is best achieved through markets as unfettered and transparent as possible;
- Basel I and II standards were being honoured and ensured capital adequacy.

The Treasury

- Overall institutional structure of financial regulation and the legislation;
- Informing and accounting to Parliament for the management of serious problems in the financial system and measures to resolve them.

Bank of England

- Making funds available in the market to address fluctuations in liquidity;
- Overseeing the financial system including systemic weaknesses;
- Undertaking under exceptional circumstances, official operations under the Tripartite arrangements including the Memorandum on Financial Stability and to limit risk of problems affecting particular institutions and spreading to other parts of the financial system.

Principles based regulation post Northern Rock nationalisation

- FSA's own review found:
- Lack of sufficient supervisory engagement with Northern Rock;
- Lack of adequate oversight;
- Inadequate resources in the direct supervision of the firm;
- Lack of intensity in ensuring all available risk information was available to inform its supervisory actions.

Treasury Committee

- Criticism of the business model adopted by Northern Rock;
- The reckless nature of the model adopted;
- The FSA did not supervise Northern Rock adequately;
- The FSA failed to tackle the fundamental weaknesses in the Northern Rock business model;
- The National Audit Office also found an absence in communication between the Treasury, FSA and Bank of England.

Turner Review

- This failure [by the FSA] to spot emerging issues was rooted in the paucity of macro-prudential, systemic and system wide analysis” Lord Turner (March, 2009);
- FSA response is to adopt a more integrated approach to supervising individual firms. “...To analyse fully risks inherent in a given firm, the supervisor must have oversight of both the full range of the firm’s business and its prudential and conduct issue...”.
- The future of regulation - “outcomes focused regulation”.

The UK Regulatory Culture

- An accounting perspective: An assumption that “The UK’s principles based accounting was superior to the US rules based approach and philosophy” Post Enron the “superiority of the UK system was largely untested;
- A regulatory standpoint: Light touch regulation was favoured from 1985 DTI *Lifting the Burden*;
- Deregulation policy followed from the Deregulation and Contracting Out Act 1994, the Regulatory Reform Act 2001, the Legislative and Regulatory Reform Act 2006.

Hampton and Macrory Reports

- Hampton (2005) favoured reducing red tape and under the Better Regulation principles reduce costs and burdens;
- Macrory (2006) see the Regulatory Enforcement and Sanctions Act 2008 favours deregulation; strengthening criminal type sanctions such as fines and charges but through regulatory agencies.

Protecting the Public Interest

- Public interest is defined by the obligation to hold to account the expenditure and application of public money on behalf of taxpayers;
- The Banking (Special Provisions) Act 2008 allows Treasury intervention on conditions of “.. protecting the public interest where financial assistance has been provided by the Treasury to the deposit-taker for the purpose of maintaining the stability of the UK financial system”.

Conclusions

- Public law provides a set of standards and legal obligations in the public interest;
- Accountability and oversight are necessary to provide adequate public protection; Two proposals may be advanced:
- Post-legislative scrutiny of Banking legislation;
- Establishing a standing select committee to supervise the Tripartite arrangements.