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Regulating banks: who is to blame and what comes next?

As we have become adjusted to the fallout from the turmoil in the financial markets, the focus of attention has moved to assessing what went wrong and what can be done to prevent it happening again. Inevitably, commentators have also been looking around for someone to blame. Peter Snowdon, Partner in the Financial Services Group of Norton Rose, presents a view of what happened and what action is likely to be taken next

While it is possible to point to failings of both individuals and institutions in some high-profile matters, the crisis that has gripped the financial markets for almost two years was caused by a number of factors and involved numerous parties. Banks, investment firms, politicians and regulators all played a role. However, it should be remembered that much of the over-lending can also be characterised as over-borrowing by both businesses and individuals. The fact that 'everyone was doing it' does not excuse the failings of those involved, but it is useful to remind ourselves that the desire to finger individuals for the crisis we are now in is an oversimplification of a problem which has wide-ranging and complex causes.

This article focuses on banks, exploring what went wrong and looking at certain ideas that might help reduce the risk that similar problems will happen again.

The regulatory structure

As is well known, day-to-day regulation of UK banks is carried out by the Financial Services Authority (FSA). Since the advent of the FSA, the Bank of England no longer has a role in the direct regulation of banks but continues to play a key role as it oversees the stability of the financial system as a whole. The Treasury retains political responsibility for both the FSA and the Bank of England although both institutions are independent of direct government control. No review of UK regulation would be complete without a mention of the EU, and in particular, the increasing raft of Directives and regulations that lie behind much of domestic regulation.

It seems unlikely that there will be a radical change to this structure. Speculation that the day-to-day regulation of banks will be returned to the Bank of England seems misguided for the time being and, in any event, the collapse of Barings, among others, demonstrates that the Bank of England can make mistakes as well.

Recent rumblings at the European level have raised again the spectre of a super-European regulator, but there is unlikely to be sufficient political will to make this a reality and the UK would be likely to fight such moves tooth and nail. However, it is probable that there will be closer working at the European level. Interested parties, including the FSA, are likely to push for a reform of some of the single market legislation, particularly where they perceive that current legislation fails to adequately mitigate risk to retail consumers.

Cooperation between the FSA, the Bank of England and the Treasury will be closer in future. The relationship pre-crisis was sometimes awkward, but all three now acknowledge that there needs to be more effective cooperation if the system is to function properly, and that each of them must have a clearly defined role. Memoranda of understanding are being reformed to reflect this and new legislation such as the Banking Act seeks to apportion responsibilities more effectively.

FSA regulation

The FSA has admitted that it failed over Northern Rock and that improvements need to be made. It has said openly that its supervision of Northern Rock did not meet adequate standards, that it failed to make proper supervisory visits and it failed to ask the questions that it should have done. Its very open review of the collapse of Northern Rock accepts that there were failings in the regulatory team assigned to the bank and that there was a lack of continuity. The FSA accepts that had it followed its own internal requirements the bank would have been subject to more challenge about its policies and harder questions would have been asked. Given Northern Rock's funding model, failure might not have been avoided, but it might not have been so traumatic.

The banks also took advantage of the monetary policy in the 1990s when low interest rates facilitated an increase in lending and the growth of leverage in the financial system. The increasing use of securitisation by the banks served only to compound the problem, facilitating the massive build-up of debt. The 'originate and distribute' model, the use of special purpose vehicles, and the development of ever more complex structures meant that in some cases it seems that no one really knew what risks they were taking on.

The instruments, structures and business models developed by the banks were complex and opaque even within the institutions themselves. Yet such practices became widespread. In some cases banks did not have the controls that they should have had, and in others the controls were not as good as they should have been.

There was heavy reliance on the credit ratings agencies because of the complexity of the financial instruments. It seems that some instruments were given high ratings when subsequently they turned out to be of very low value. It is now generally accepted that the way in which credit ratings agencies operate must be reviewed. In particular, the identification and management of potential conflicts represents a notable weakness.

The way forward

The government and the FSA are also beginning to look at more long-term measures to restore the confidence in the regulatory system and financial services industry. However, it will not be possible for one country to act alone and it is important that the reform of regulation in the UK is coordinated with moves being adopted in other markets so that the risk of regulatory arbitrage can be mitigated and the competitive position of the UK financial services industry is not undermined.

It is generally accepted that the prudential regulation of banks was not adequate and that the Basel Accord needs to be upgraded and developed to deal with significant weaknesses in the way regulatory capital is currently calculated. One such weakness is that the current rules are procyclical in approach and result in banks failing to put aside sufficient capital when there is a boom. Existing rules require banks to hold capital against a quantified risk, and do not take adequate account of other types of risk. One of the realisations that have arisen from the current crisis is that in many of the key financial services centres, regulatory obligations underestimated the amount of regulatory capital that banks would need to hold in order to sustain their businesses in a downturn.

However, one notable exception to this is Spain which has developed quite a different approach to the regulation of banks. The Spanish financial regulator required banks to use so-called dynamic provisioning through regulatory rules adopted at the end of the last century. In summary, these rules required the banks to make provision for bad debts when times were good, so building up reserves for the inevitable downturn in the markets. Unsurprisingly, the Spanish banks complained bitterly at the time, but it now looks as if the imposition of these requirements was a shrewd move by Spanish regulators, placing the Spanish banks in a much better place to face the credit crisis than banks in some other jurisdictions. The Spanish position remains controversial, with some arguing that these rules are in conflict with the requirements of the Capital Requirements Directive which implements the Basel II Accord at European level. Given the relatively healthy position of Spanish banks, dynamic provisioning may well be one idea that UK regulatory authorities should be considering for the future.

It is clear that the FSA is going to take a much tougher regulatory stance in future. It has admitted that it made mistakes in its regulation and that regulators were too focused on the institution-by-institution supervision of idiosyncratic risk, and that bigger-picture issues were either missed or largely ignored. In future, therefore, the regulators are likely to conduct a more sectoral analysis and make a point of examining business models as a whole. It is possible that the Bank of England will provide input at this macro level as its role means that it is uniquely placed to identify bigger-picture market trends. It also seems inevitable that arrangements for the regulation of large and complex banks that operate at a multi-jurisdictional level will be re-examined and improved with a view to developing new structures for cooperation between national regulators.

Liquidity

The FSA is firmly of the view that inadequate liquidity risk management, particularly in international groups, was a key factor in the failure of a number of the businesses that it supervised in the UK. Adair Turner, Chairman of the FSA, has described liquidity as of equal importance to capital adequacy. Critics of the current regime say that the FSA focused too much on credit and market risk, and that there was a notable failure to understand the exposure presented by the way in which it oversaw the management of liquidity by firms it supervised.

In December 2008 the FSA published a wide-ranging consultation paper, which contains proposals for a root and branch reform of the current liquidity requirements.[1] The paper recommends major changes to the regulation of liquidity supervision, including proposals to introduce significant new obligations regarding banks' liquidity management arrangements as well as detailed new reporting requirements.

One of the issues that the FSA has identified in its review of liquidity risk is the position of international groups. It argues that focusing on going concern liquidity requirements alone is inadequate. It notes that significant problems with liquidity arose in the gone concern context (ie, when a firm fell into insolvency) when international businesses broke up into a series of individual entities, which where unable to call on central liquidity resources and as a result were unable to meet their obligations to local counterparties.

Upgrading supervision and remuneration

One consequence of the credit crisis that firms are likely to see sooner rather than later is an increase in FSA supervision. The FSA is currently increasing its supervisory capacity and hiring significant numbers of additional staff to enable it to adopt a more intensive supervisory approach. Apart from closer scrutiny, firms will also notice higher fees as the cost of regulation is set to grow significantly.

Some commentators have suggested that there should be more movement between industry and the regulator. While recent market knowledge is always useful, it is important to recognise that some of the best people at the FSA are career regulators. One of the risks faced by the regulator is so-called regulatory capture, where the regulatory personnel become too close to firms and cease to present a challenge to firms' business models. This may have been part of the problem with the FSA's relationship with Northern Rock. It seems that some regulatory staff may have lost sight of the importance of challenging and testing business models.

The banks themselves must make changes in order to enable the regulators to carry out their roles effectively. There needs to be more transparency. The banks must make an effort to ensure that there is greater understanding of the complex structures that have appeared in the market and which have hindered the regulators' ability to understand and assess underlying risks. More generally, it is important that within institutions there is a clear understanding of the business being undertaken and the risks that such business entails. This means that banks need to establish adequate systems and controls to manage the risks presented by complex innovative products and structures, but it also requires that institutions do not lose sight of basic management techniques such as clear lines of responsibility, establishing adequate communication and ensuring that staff are competent and have the capability to carry out their functions properly.

More generally, it is now widely accepted that some remuneration arrangements employed by certain banks incentivised high-risk behaviour by staff. The FSA has already published a draft code of practice on remuneration policies and it is possible that there will be further regulatory initiatives in this area in due course.

Conclusion

Taking a step back, what then are the main conclusions from the recent debate on banking regulation?

- Given the interaction between individual bank and system risks, there is a clear case for improved cooperation among the UK regulatory authorities.

- There is a need for significant improvements in cross-border cooperation, although radical institutional change does not appear to be on the agenda.

- Prudential regulation will need to be enhanced, potentially leading to higher capital requirements for banks, increased focus on liquidity, and more direct supervision.

- There is a need for improved transparency of information relating to the risks banks take on, particularly as regards complex financial instruments.

Given the extent of the financial shocks to have hit the sector, even reform of the above nature may understate the changes likely to emerge in the banking regulatory framework.

Peter Snowdon

[1] Financial Services Authority (2008), 'Strengthening Liquidity Standards', Consultation Paper 08/22, December.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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