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'Twin Peaks' Revisited…
a second chance for regulatory reform

Michael W. Taylor

Preface

Back in 1995, Michael Taylor wrote a CSFI report advocating the “Twin Peaks” approach to regulation. His first radical suggestion – that retaining the regulatory divide between banking, insurance and securities was obsolete – has become conventional wisdom. The second, that each regulator should have a clear objective, has been proved right in spades by the crisis. He correctly predicted that if prudential regulation were mixed with consumer protection, the former would lose out.

As a think-tank, we should be able to say “I told you so” without any false modesty. But this is not enough. Michael’s third proposition all those years ago was that the regulatory structure should mirror the industry. In other words, it must keep up with profound changes in the DNA of the regulated. The biggest change has been the emergence of large, complex financial institutions that are not only multi-functional and international but “too big to fail”. As Michael points out, this calls time on the myth that these entities are constrained by the threat of bankruptcy.

That leaves two alternatives: break up the banks, as advocated by John Kay in his recent CSFI report, Narrow Banking, or reform the regulatory structure so that it is designed to constrain the activities of the TBTF firms. This should be done alongside ensuring that prudential and consumer protection goals are pursued separately.

In Twin Peaks Revisited, Michael sets out a blueprint for reforming the regulatory structure. Without wishing to rule out further instalments of Twin Peaks, this can be seen as the definitive attempt to address the blurred purposes of existing regulators and the gaps between them. The original report was a must-read and has become a seminal work on regulatory structure. The same is, and I’m sure will be, true of this one.

Jane Fuller
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Summary

The financial crisis requires a fundamental rethink of the institutional structures of regulation, and the debate needs to be guided by some fundamental principles.

The fundamental principles, based on those that shaped the original *Twin Peaks* paper, are as follows:

- *First*, in a modern financial system, the traditional tripartite distinction between banking, securities and insurance has become obsolete and needs to be replaced by a regulatory structure that focuses on the objectives of regulation.

- *Second*, each regulatory agency should have a clear and unambiguous mandate and should have a specific objective for which it can be held accountable.

- *Third*, the regulatory structure needs to mirror the structure of the industry that is being regulated; for example a financial industry in which some firms are too big to fail requires different regulatory arrangements to one in which all firms are at the risk of bankruptcy.

The first and second principles have been validated by events both before and during the global financial crisis.

The third principle has identified the problem of “too big (interconnected) to fail firms” (also called LCFIs) as the leading problem of post-crisis regulation. A systemic risk “tax” should be imposed on these firms through a combination of higher prudential requirements and contributions to a financial stability fund. A specialist financial regulator, the Financial Stability Commission, should be established with the sole purpose of the prudential regulation of these firms.

The central bank has a vital role to play in ensuring systemic stability and as a crisis manager. Its stability focus should be on the functioning of markets and the interconnections between markets, rather than on the soundness of individual institutions. The regulation of LCFIs should be the responsibility of a specialist regulatory agency, the Financial Stability Commission, which could be established as a subsidiary of the central bank.

The prudential regulation of non-systemic firms could be combined with sales practice and market conduct regulation in a Consumer Protection Commission. In the UK this could be the successor organisation of the FSA. In the US these functions could be unbundled into three separate regulatory agencies.

Crisis management arrangements should be streamlined. Although the Treasury has the right to be kept informed of developments, it does not need to lead the decision-making process unless public funds have to be committed as solvency support. Where the problem is one of liquidity the central bank should be in the lead. Regulatory agencies should play a supporting role to the central bank, or the Treasury, depending on the nature of the problem.
1. Introduction

The global financial crisis has revealed a colossal failure of regulation that was due, at least in part, to weaknesses of regulatory structure. In the United States, the gaps resulting from its complex and fragmented regulatory system permitted both institutions and entire markets to evade proper oversight. Consumer protection regulations were either non-existent or not enforced. In Britain, the unclear division of responsibility between the Bank of England and the Financial Services Authority contributed both to the failure to detect potential systemic problems sufficiently early and to inefficient crisis management arrangements when these problems materialised. These failures cannot be dismissed as trivial or superficial. They have cost the British exchequer many times the combined costs of BCCI, Barings and the pensions mis-selling “scandal” – which, together, provided the current regime with its justification. In consequence, although the institutional structure of regulation is not the only significant issue to be thrown up by the financial crisis, it is essential that it is subjected to a thorough debate. In this paper, I will argue that the starting point for debate should be the principles contained in my December 1995 paper for the Centre for the Study of Financial Innovation, *Twin Peaks: A Regulatory Structure for the New Century.*

This paper proposed that, instead of being structured around the traditional tripartite distinction of banking, securities and insurance, there should in future be two regulatory agencies, a Financial Stability Commission and a Consumer Protection Commission. The first would be responsible for ensuring the stability of the financial system as a whole, primarily through the application of prudential regulations. The second would be charged with ensuring that firms deal with their (retail) customers in a fair and transparent manner. The two Commissions would be responsible for discharging their mandate irrespective of the legal form of the firms they regulated.

More important than the specific institutional arrangements that *Twin Peaks* proposed were the principles on which they were based. These can be summarised as follows:

- **First, in a modern financial system the traditional tripartite distinction between banking, securities and insurance has become obsolete and needs to be replaced by a regulatory structure that focuses on the objectives of regulation.**

- **Second, each regulatory agency should have a clear and unambiguous mandate and should have a specific objective for which it can be held accountable.**

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2. I shall throughout refer to both these agencies as “Commissions” as I believe that they should be structured as a multi-member commission, thus reducing the personalisation of regulation that has been one of the besetting sins of the UK’s regulatory arrangements.
Third, the regulatory structure needs to mirror the structure of the industry that is being regulated; for example, a financial industry in which some firms are too big to fail requires different regulatory arrangements to one in which all firms are at the risk of bankruptcy.

Although in the mid-1990s it was heretical to argue that banks were not the only source of systemic risk, the first principle is now no longer in dispute. One matter on which the recent White Papers from the UK Treasury and the Conservative opposition agree is that banks should be supervised alongside other types of financial firm – a radical view a little over a decade ago. The emergence of financial conglomerates and the rise of new financial markets, such as those for Credit Default Swaps, have raised at least some of these firms to the same level of systemic importance as large banks. It is noteworthy that the chain of collapse in the US during the autumn of 2008 was caused by non-banks – notably, Fannie Mae and Freddie Mac, Lehman Brothers and AIG.

Recent events have also affirmed the second principle. Regulatory agencies with too many tasks and too many different objectives are at risk of doing them badly. The point is made most clearly by the combination of prudential and consumer protection regulation. The Turner Review has acknowledged that the FSA did not devote sufficient resources to prudential regulation prior to the crisis. The FSA's management chose to dedicate resources to high-frequency events (such as consumer complaints) rather than low frequency but high-impact events, such as bank failures; I will discuss later why this outcome should not have been surprising. The Federal Reserve, as a central bank, made the opposite decision and has been roundly criticised for its failure to use its consumer protection powers. When prudential and consumer protection regulation are combined in a single agency, at least one of them is likely to be done badly.

However, it is with respect to the third principle that the financial crisis could potentially have the biggest impact. After the crisis deepened in the closing months of 2008, the realisation grew that there is now a class of financial institutions that are unquestionably “too big (or interconnected) to fail” (TBTF). For decades finance ministries, central banks and regulators have tried hard to maintain the fiction that no matter how big a financial firm might be, the threat of bankruptcy hangs over it. That fiction has been well and truly exploded by the financial crisis.

How the problem of TBTF firms is solved will determine the future shape of the financial services industry. These decisions should in turn shape the decisions about the type of regulatory structure we need. To understand why this is the case, consider for a moment one possible solution to the TBTF problem.

Seen with the benefit of hindsight, Twin Peaks was written approximately half way through a great experiment in which the market, rather than regulation, was allowed to shape financial industry structures. Structural regulation (either informal, as in the UK, or formal, as in the US) was a thing of the past. Market forces and commercial decisions would determine the existence, or otherwise, of financial conglomerates and large border-crossing financial firms (which we have now come to call large complex financial institutions, or LCFIs).
We have seen the outcome of the experiment – and the result has been to give structural regulation a new lease of life. Many influential voices have called for a rebirth of the Glass-Steagall Act with its mandatory separation of commercial from investment banking. The crisis has shown, they argue, that permitting this combination of activities within a single institution or group is inherently risky. The only safe course is to ring-fence the “public utility” functions of banks, leaving the “casinos” of active trading operations to fend for themselves. In contrast, critics of the reintroduction of structural regulation point out the costs that this would impose, especially in terms of creating new inefficiencies in the financial system. Not all financial innovation in the past few decades has been detrimental, and some genuine gains would be lost by the re-imposition of structural barriers. The elaborate network of interconnections that has been built up between firms over the past few decades could not be dismantled except at great cost. Moreover, there is no guarantee that structural barriers would be effective in insulating firms from the type of financial contagion that we have just witnessed.

Nonetheless, if “utility” banking is separated from “casino” banking, then the case for a Twin Peaks type approach would disappear. The regulatory structure would instead need to map the difference between utility banks and the casinos.

The assumption of this paper is that structural regulation will not be reimposed. The combination of the lack of political will and the practical obstacles to a “new Glass-Steagall” will defeat such attempts. Instead, this paper supposes that industry structures will remain largely market-determined, and that LCFIs will continue to be a major presence in the financial system. However, it also seems safe to assume that one of the leading aims of regulatory policy in future will be to constrain risk-taking by these TBTF firms. The crisis has left no doubt that at least some firms operate without the threat of bankruptcy that is essential to the functioning of a market economy. Policies must be developed to correct this state of affairs.

The policy most likely to be adopted for this purpose is a systemic risk “tax” which, unlike structural regulation, seeks to change the balance of incentives for firms to become too big to fail (“incentive-compatible” in the economics jargon). The tax aims to deter firms from becoming TBTF in the first place, or at least to raise the cost of keeping this status. It could take one of two forms. The version that has been most thoroughly discussed to date is to impose higher capital and liquidity requirements for TBTF institutions (as proposed both by Turner in the UK and by the Swiss National Bank), possibly in the form of a “systemic risk” addition to capital requirements (as recently proposed by the BIS). The second approach, which does not necessarily exclude the first, would be to require LCFIs to make contributions to a “financial stability fund”. The basic principle of this fund would be similar to a pre-funded deposit insurance scheme, with the fund able to act as principal if called on to provide additional capital to TBTF firms. In effect, the contributions to the fund would be premiums paid in return for a form of capital insurance.

3. Throughout the rest of this paper I will use LCFIs to refer to all firms that are either too big or too interconnected to fail.

If the systemic risk tax, in either or both of its possible forms, is imposed on LCFIs, then we must consider which regulatory agency will be best able to administer it. This in turn raises the issue of the regulation of firms that are not TBTF and which, therefore, would not be subject to the tax.

The prudential regulation of these firms serves a different purpose to that of LCFIs. Non-systemic firms need prudential regulation primarily to protect consumers by reducing the risk of failure – and, if they do fail, to permit them to be resolved in an orderly way. The question is whether they should be regulated alongside LCFIs or separately. Moreover, sales practice regulation – ensuring the adequate disclosure of risks, competition between product providers and so on – applies to all firms, LCFI and non-systemic alike, that deal with the public. It is, therefore, yet another function, as is policing financial markets, to prevent manipulation and insider dealing. How should all these different functions fit together? And where do we fit the responsibility for ensuring the stability of the overall system? We need a map and a compass to sort out the range of configurations.

In the rest of this paper, I hope to provide this.

The map will consist of three concentric rings. In the centre will be a core of tightly regulated LCFIs that are too big to fail, and are therefore subject to the systemic risk tax. Administering the tax is a job for a specialised regulatory agency. In the inner periphery will be those firms that are not TBTF, but which need prudential regulation to ensure that they have sufficient capital to back their promises to their customers and that, if they do fail, they can be wound up in an orderly way. They, too, should have their own regulator. In the outer periphery are those firms whose insolvency would individually pose neither a risk to the system nor to their customers. Firms in the outer periphery may not require a prudential regulator at all, but could if necessary be regulated alongside those of the inner periphery.

Linking together these three concentric rings are two regulatory functions:

- One relates to sales practice, or conduct of business, regulation. This applies to any firm that deals with the public. Ideally, this function should be performed by a dedicated regulatory agency but, in the British context, it could be combined with the prudential regulation of firms in the periphery and carried out by a reformed FSA.

- The second function is concerned with ensuring the stability of the financial system as a whole. Threats to financial stability could originate from anywhere in the three circles – including in the outer periphery if a sufficient number of firms (such as hedge funds) move in the same direction at once. The central bank is best suited to perform this function, collecting information from firms in each of the three circles, analysing market developments and responding to them – including through its decisions on short-term interest rates.

In what follows I will explain the reasoning behind this regulatory structure.
2. The blurring of boundaries

The first principle of the Twin Peaks analysis was the notion that the traditional distinctions between banking, securities and insurance had become obsolete. This has come to be known as the “blurring of boundaries” argument – a phrase appropriated by the (then) Chancellor of the Exchequer, Gordon Brown, in announcing the decision to create a single financial services regulator for the UK. This argument had two dimensions. The first related to consumer protection and the observation that many products sold to the public no longer easily fitted into the traditional framework of deposit, insurance or investment contracts. Accordingly, it helped to justify the case for a single consumer protection agency for which these distinctions would be an irrelevance.

The blurring of boundaries argument also had a financial stability dimension. The traditional view was that banks were the only systemically important institutions. As a result, it was argued, banks were a “special” type of financial intermediary and their supervision was a natural outgrowth of the central bank’s financial stability remit, most notably its role as lender of last resort. This meant that bank regulation needed to be kept separate from other forms of regulation, and should be a core central bank function.

By contrast, Twin Peaks contended that the nature of systemic risk had changed and that a wider range of firms ought to be considered systemically important. Central to this analysis were two trends that had changed the concept of systemic risk:

- The growth of financial conglomerates in which banking, securities and insurance firms were combined; and

- “functional despecialisation”, the tendency of financial firms to take on risks that were once the preserve of other types of financial intermediary.

The emergence of financial conglomerates changed the nature of systemic risk because of both their size and the ownership relationships within them. Even by the mid-1990s, it had become clear that these institutions, with border-crossing operations, would increasingly dominate the financial services industry. Since then a growing percentage of financial sector assets have become concentrated in the hands of relatively few conglomerate groups. The financial crisis has served to accelerate this concentration trend, particularly following the acquisitions of Bear Stearns and Merrill Lynch by commercial banks and other mergers that have taken place with official blessing.

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5. In a speech to the House of Commons on 20th May 1997.
Size was one factor; ownership another. By the mid-1990s, financial conglomerates were being run on an integrated basis, with centralised risk control, irrespective of the legal entity in which the risk arose. Again, this trend has accelerated. Large firms operating in a range of locations and with exposures to many different markets have sought the benefits of diversification. At the same time, however, the likelihood that shocks can be transmitted throughout the group has increased. Problems in one business unit of a conglomerate can lead to a loss of market access for other units, or destroy confidence in the group as a whole. The financial crisis has provided several examples – most notably the problems in AIG’s financial products division, which undermined confidence in a long-established, triple-A rated and otherwise conservatively managed insurance group.

In parallel to this development, the emergence of new financial markets and products also radically changed the linkages between firms. This gave rise to “functional despecialisation” in which firms with different legal forms (banks, insurers, securities firms) began to resemble each other in the types of risks they assumed. Securitisation provided one such mechanism: it exposed banks to market and liquidity pipeline risks that they had not previously faced, while other financial intermediaries which purchased asset-backed securities were exposed to the credit risk previously borne by banks.

However, the most significant development was the entry of a diverse range of financial firms into proprietary trading activities, especially in the over-the-counter derivatives markets. The explosive growth of the Credit Default Swap (CDS) market forged even tighter connections between the banking industry and non-banks. Like earlier derivatives markets, this was OTC, one in which banks and other holders of default risk came to rely on a variety of financial intermediaries for credit risk mitigation. These intermediaries included investment banks and insurance companies, which through these activities became systemically important.

Of course, not all investment banks and insurance companies had suddenly become systemically important, and those that stuck to their traditional business models remained unlikely to put the system as a whole at risk. But the expansion of some large non-banks into proprietary trading in OTC derivatives resulted in them becoming “too interconnected to fail” – a phrase that was coined when Bear Stearns teetered on the brink in March 2008. On the traditional view, Bear Stearns would not have been considered systemically important; however, the episode confirmed the argument of Twin Peaks that “the rise of the OTC markets means that we must extend our concept of what constitutes a systemically important firm”.

To this extent, events before and during the financial crisis have served to validate the Twin Peaks analysis: a wider range of firms must now be recognised as systemically important. Although heretical at the time, this view is now widely shared. It has informed such varied reform proposals as the Paulson plan in the US, the more recent Obama Administration proposals, as well as the White Papers issued by the UK Treasury and the Conservative party.
3. The objectives of financial regulation

If the traditional tripartite distinction between banking, securities and insurance is no longer an adequate basis on which to structure the institutions of regulation, what is the alternative? *Twin Peaks* argued for a structure based on regulatory objectives, which might be called (with apologies to management theorists) “Regulation by Objective”.

*Twin Peaks* set out two fundamental objectives for financial regulation:

- to ensure the stability and soundness of the financial system (“systemic protection”); and
- to protect individual depositors, investors and policy-holders to the extent that they cannot reasonably be expected to protect their own interests (“consumer protection”).

These objectives have not changed in the intervening years, but they do need a little more unpacking than they were given in the original paper.

The systemic protection objective can be unbundled into three regulatory functions:

(i) **Ensuring the stability of the financial system**: This function is concerned with the detection and prevention of emerging system-wide risks, no matter in which markets or institutions they might be located. The primary focus is on the way firms are interconnected through financial markets, and thus on the mechanisms by which problems in one market can be transmitted to others, leading to generalised instability. The soundness of individual institutions is of only secondary interest from this point of view. This function should be as much concerned with the prevention of risks as with their detection. An important preventative tool is to ensure the robustness of market infrastructure so that systems for payment, clearing and settlement will cope with periods of stress. Other preventative tools may also be required, and a good deal of the recent policy debate has been about this: proposals for “macroprudential regulation” and counter-cyclical capital belong to this category.

(ii) **Crisis management arrangements**: This concerns the policies and procedures for dealing with problems in the financial system when things go wrong. They include the central bank’s provision of liquidity against good quality collateral (lending of last resort) and “emergency liquidity assistance” (ELA) to troubled institutions, which may lack forms of collateral normally accepted by the central bank. They also include a resolution mechanism for
Firms that are considered 'bankruptcy remote'

failed or failing financial intermediaries. Firms that do not fall into the LCFI category should be subject to orderly winding up procedures, involving (for example) the transfer of their business to another healthy institution. For LCFIs, the matter is much more complex. Although some policies (such as the idea of requiring institutions to write a “living will”, or to segregate their business activities into separate subsidiaries) may facilitate their orderly winding-up, these are firms that by definition are difficult to resolve without causing system-wide problems – potentially in a number of overseas financial jurisdictions as well as the home one.

(iii) **The prudential regulation of LCFIs:** These are either so big or so interconnected that their failure would cause intolerable disruption to the financial system. As we have seen, it is now accepted that banks are not the only institutions that could potentially have this impact. The focus of attention also needs to be on investment banks, insurance companies and even hedge funds if they are large and leveraged, which may be a consequence of their activities in the OTC derivatives markets. Due to their size and/or degree of interconnectedness these firms can be considered “bankruptcy-remote” in the sense that there is a presumption that they will have to be bailed out if they get into difficulties. Given that it is no longer possible to maintain the fiction that no firm should automatically expect to receive public support, it is necessary to consider whether it is either possible or desirable to define in advance a sub-set of financial intermediaries as being TBTF. They might include banks, investment banks and insurance companies, depending on the nature of their activities. The purpose of identifying this sub-set of financial firms would be to subject them to different, and higher, regulatory requirements and supervisory oversight than other firms – the systemic risk “tax”. Properly structured, such a system of incentives might deter financial institutions from seeking to become too big to fail in the first place, or might put incentives in place for TBTF firms to shrink their balance sheets without resorting to more explicit size limitations.

Others subject to orderly winding up

The consumer protection objective can also be unbundled into three sub-functions:

(i) **The prudential regulation of firms that are not LCFIs:** Although many of these firms may also be subject to capital and liquidity requirements, the purpose of these requirements is different to those applied to LCFIs. In the latter case, the primary objective is to impose the systemic risk “tax”. By contrast, firms that are not bankruptcy-remote need to be subject to prudential regulation for two main purposes: first, to ensure that they are able to honour their contracts with their customers (Equitable Life provides an example from the insurance industry, Dunfermline Building Society an example among deposit takers); and second, to provide capital and liquidity buffers to facilitate their orderly winding up.

(ii) **Consumer protection regulation:** The prudential regulation of non-LFCIs can be thought of as a type of consumer protection regulation, in that it tries to...
Encouraging competition is an important component

ensure that firms will be able to honour their contracts. However, this function refers more narrowly to regulation that governs firms’ dealings with their (retail) customers. It is sometimes referred to as “sales practice” or “conduct of business” regulation. The purpose of this type of regulation is to overcome information imbalances between the firm and its customers. It aims to ensure fairness and transparency in the relationship, and the disclosure of both relevant risks and fees and charges. Encouraging competition in the provision of consumer financial services, by working to remove barriers to entry, should be an important component of this regulatory function. To a large extent, the panoply of consumer protection regulation serves to treat the symptoms of financial product markets that are insufficiently competitive.

(iii) Ensuring that financial markets operate in a fair and transparent manner: Rather than relating to a firm’s dealings with its customers at an individual level, this function is instead concerned with the functioning of markets as institutions, covering such matters as listing requirements, public disclosures, insider dealing and market manipulation.

Thus, although there are only two regulatory objectives, there are six regulatory functions. At its most basic, the problem of designing an institutional structure for regulation is that of deciding which of these functions belong together in the same institution. At one extreme – the UK after 1997 – almost all of these functions were combined in a single agency (the exceptions being the first systemic protection function, which was, rather vaguely, assigned to the Bank of England and the crisis management function, which was not clearly assigned at all). At the other extreme, each of these functions could be discharged by a different agency. Thus the central bank would be responsible for the promotion of financial stability; there would be a prudential regulator for LCFIs; and there would be an agency with responsibility for resolving failed or failing financial institutions. In parallel, there would be a single prudential regulator for firms that are not LCFIs, a consumer protection regulator and a market conduct regulator. This structure is similar to the blueprint proposed by the US Treasury, under Henry Paulson, in March 2008.6

This structure is, however, only possible in countries with large financial markets and enough financial institutions to make six separate agencies viable. It is an option for the US and, perhaps, for the EU should the latter ever establish a Union-wide regulatory system. For most countries, however, a multiplicity of agencies is not a realistic option. Moreover, there are various synergies between the different regulatory functions, and it is necessary to consider whether they can be achieved by combining some of them within the same agency.

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4. The allocation of financial stability functions

Ensuring financial system stability

The most straightforward of the functions to allocate is the first – ensuring the stability of the financial system. This is a natural central banking function. Tommaso Padoa-Schioppa (ex IMF, ECB, BIS and a former minister of finance for Italy) once described this responsibility as part of the “genetic code” of central banks. Increasingly, such a role has become formalised in statute – for example, by Britain’s 2009 Banking Act.

Traditionally, the central bank was seen as exercising its financial stability remit only over deposit-taking institutions, notably by acting as lender of last resort by providing both general liquidity insurance and emergency liquidity assistance (ELA) to particular institutions. However, the global financial crisis has put the final nail in the coffin of the traditional view that only banks are systemically important, and (at least in the US) ELA has been extended to some non-bank LCFIs. The central bank now needs to keep close tabs on a wide range of systemically important firms, not just the deposit-taking institutions that are its traditional counterparties. This raises the question of how the central bank can discharge its financial stability function under these changed conditions.

As already mentioned, the primary focus should be on the interconnection between institutions – i.e. with the functioning of markets. This is not market conduct regulation. It is instead concerned with the dynamics and interaction of firms to ensure that markets continue to function smoothly and that there are no significant spill-overs from one market to another, or into the real economy. The central bank has had a historical interest in the proper functioning of the money markets, through which its monetary policy is transmitted. It is a natural extension of this role for its surveillance to embrace those other markets that form part of the essential infrastructure of a modern financial system – including the derivatives and securitisation markets. The central bank’s macroprudential surveillance should, therefore, be concentrated on these financial markets. The aim will be to detect possible stress points, including those created by exposures to common risks and those arising from herd behaviour.

To perform this role, the central bank will need to collect a wide range of data from a great variety of firms, including but not limited to LCFIs. It also needs to hold regular liaison meetings with a wide range of market participants to gauge

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the mood of the markets; statistical data alone will not give a “feel” for what is happening. In short, the central bank needs to have the ability to form an overview of the interaction of all firms in the market, irrespective of their size or systemic importance.

Proposed councils of regulators, such as the European Systemic Risk Board and the US Financial Services Oversight Council, could play a useful supplementary role in helping the central bank to identify issues of concern. If the central bank is not itself a regulator, it will need frequent input from the regulatory agencies, in parallel to the information it gathers from market participants. However, these councils cannot substitute for the central bank’s role in overseeing financial stability, especially as it alone possesses effective tools to combat emerging problems. Nor should the central bank be placed in the position of having to rely on other agencies for the information that it needs. It must possess its own information-gathering powers. Moreover, councils are effective mechanisms for diffusing responsibility, whereas the aim should be to ensure that one agency alone is clearly assigned this role.

The central bank must also be able to do more than merely issue warnings when it perceives that aggregate risks are growing. A fundamental flaw of the current British system is that it leaves the Bank of England without the tools to give force to its warnings. The precise nature of these tools is being debated, although there are grounds for doubting how effective such ideas as counter-cyclical capital will be in practice. Fortunately, the central bank already possesses the most important tool of all – its control over short-term interest rates. This is not to suggest that interest rate decisions should be subordinated to the financial stability goal, merely to point out that targeting consumer price inflation is a necessary, but certainly not a sufficient, condition for successful monetary policy. It is important that the monetary authority factors in all the possible sources of inflation, including those originating in the financial sector. To this belongs the seemingly forgotten art of taking away the punchbowl before the party gets going, as so memorably described by William McChesney Martin, former chairman of the US Federal Reserve.

Crisis management arrangements

The second systemic protection function also involves the central bank. Its financial stability surveillance function will give it a unique perspective from which to detect the build-up of risks in the system and to take pre-emptive action. Unlike regulatory agencies, which have few financial resources of their own, the central bank is uniquely placed to provide liquidity insurance through last resort lending and ELA. Following the precedent set by the Federal Reserve, and given the analysis of the changing nature of systemic risk, these loans should be available to a wider range of counterparties than previously – not just to banks but to non-bank LCFIs. Even
if regulatory agencies can call upon an insurance fund (and I will argue for creating such a fund), their resources are limited and will be inadequate to deal with a genuinely systemic problem.

The other agency with deep pockets is, of course, the finance ministry (or Treasury). It has the ability to commit taxpayers’ money and to provide solvency support when necessary. However, the Memorandum of Understanding among Britain’s Tripartite Authorities does not distinguish between liquidity and solvency support; it instead refers generically to “support operations”. In both cases the Treasury sits at the apex of a pyramid, providing the glue that holds the Tripartite system together. This is an anomalous position for a finance ministry to occupy, and it is the direct result of the Bank’s lack of autonomy in crisis management. The practice of most other countries is to ensure that as long as the issue remains one of liquidity, the central bank will take the lead. It alone has (or should have) the information and the ability to react sufficiently promptly to emerging problems. In this case, the role of a regulatory agency should be clearly established as that of a handmaiden to the central bank, under an explicit obligation to provide it with all the information its needs to discharge its financial stability mandate. Clearly, the Treasury should have the right to be kept informed of these operations, but it should cease trying to micromanage them since it lacks the expertise to do so and adds an extra layer to the decision-making process when time is of the essence. Only when the issue becomes one of providing public funds for solvency support should the Treasury take the lead, with the central bank and the regulators then in supporting roles.

The location of the resolution authority is less clear cut than the location of the rest of the crisis management function. There is certainly some merit in separating it from the supervisory agency. Regulators with resolution authority tend to exercise forbearance to avoid being criticised for supervisory failings. On the other hand, the central bank can suffer from its own conflicts of interest, especially when it is a secured creditor by virtue of providing ELA. The best arrangement would be a dedicated resolution agency. Failing that, the central bank could act as the resolution authority provided that it does not have supervisory powers of its own.

Wherever the resolution authority is located, there should be a pre-funded insurance scheme with the flexibility to deploy its funds for purposes other than simply making payouts to depositors or policy-holders. The resources should be available to support a range of resolution options, including purchase (of assets) and assumption (of liabilities), and the creation of bridge banks. The use of these funds should always be subject to a “least cost” or “lower cost” test – i.e. a restructuring should only be supported if analysis shows that it is likely to be less costly to the fund than a depositor payout. However, the important point is that a pre-funded scheme is an essential component of modern crisis management arrangements.
The prudential regulation of LCFIs

The first and a large part of the second systemic protection functions belong naturally with the central bank. More controversial is whether the central bank should also be responsible for the prudential regulation of LCFIs.

The chief argument in favour of such an arrangement is that the regulation of systemically important firms would be a natural outgrowth of the central bank’s financial stability remit. In summary: given the information requirements about potential counterpartyies needed for the central bank to act as lender of last resort (especially as the provider of ELA), it is but a short step for it to have formal responsibility for ensuring that these firms observe prudential requirements. This was at the heart of the case for the Bank of England retaining its role in banking supervision in the debate that took place after the publication of *Twin Peaks*. According to some commentators, subsequent events have shown the folly of separating (banking) supervision from the central bank.

This argument overlooks the fact that the financial stability function and the prudential regulation of LCFIs are two separate responsibilities. It is clear from many other jurisdictions (and from the Bank of England’s own history8) that the central bank is capable of performing its financial stability role without direct regulatory powers of its own. However, these examples do demonstrate that in the absence of regulatory powers, the central bank requires access to information about individual institutions through the exercise of its own powers to gather information. An excessive concern with eliminating “duplication and overlap” in the UK’s post-1997 arrangements resulted in the baby of the central bank’s legitimate information needs being thrown out with the bathwater of statutory responsibility for banking supervision.

The central bank could perform the systemic stability function without also taking on the prudential regulatory function. Nonetheless, this does not necessarily mean that the prudential regulation of LCFIs should be conducted by an agency outside the central bank. To decide on the allocation of this function, we need to consider the purpose of subjecting them to prudential regulation.

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5. The purpose of regulating LCFIs and its implications for regulatory structure

In an ideal world – the one supposed in financial economists’ models – all firms should be equally exposed to the risk of bankruptcy. In the real world, however, this will never be a realistic prospect for LCFIs. As the Swiss National Bank has observed, “as a result of their cross-border activities and close linkages with major counterparties and markets, the orderly wind-down of a systemically important institution would be almost impossible (‘too interconnected to fail’).”

There is certainly much that can, and should, be done to make it easier to wind up these firms: some form of binding international agreement that would govern the insolvency of cross-border institutions would be a good place to start, as would the international pooling of bailout funds (an option I discuss later). But even with such arrangements in place – and it may take many years to agree on international insolvency arrangements – there will still be firms that are “bankruptcy-remote”, where the consequences of their failure would be so damaging to the financial system and the real economy that few policy-makers would contemplate the prospect.

Due to their special status, bankruptcy-remote firms require a different and more rigorous approach to regulation than firms that can be wound up with relatively little disruption to the system. This is the essence of the case for a systemic risk tax. The failure of an LCFI would impose an “externality” in the form of additional costs on other financial market participants, on taxpayers, and even on the real economy. The purpose of a systemic risk tax is to force the LCFIs to “internalise the externality” – to include at least part of the cost of their failure in their internal decision-making.

Among the possible components of the tax are:

- higher capital and liquidity requirements, in particular increasing the amount of capital required to back proprietary trading;
- imposing limits on firms’ activities (for example, prohibitions of certain business combinations, just as insurance companies are not allowed to conduct life and general insurance on the same balance sheet);
- limits on leverage; and
- other growth or size constraints.

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Whatever the final combination of measures, the aim should be to tax the implicit subsidy enjoyed by these firms resulting from their TBTF status. If a firm is too big to fail it should expect to have to pay for the privilege.

LCFIs should also be required to make regular contributions to a dedicated financial stability fund.

Contributions to this fund should be calibrated according to the riskiness of the firm and the extent to which it receives a TBTF subsidy. The resources of the fund would be available to inject fresh capital into LCFIs if they encountered difficulties, or to acquire some of their assets as part of an orderly resolution. The fund would thus provide solvency insurance to LCFIs as a counterpart to the liquidity insurance provided by the central bank. Like a pre-funded deposit insurance scheme, it would also create a first line of defence for the public purse since it is built up from the contributions of firms that would benefit from it. The fund might also be given a line of credit from the Treasury, with any drawings being repaid from future contributions. Only when the resources of the fund were unable to meet the size of a problem would the taxpayer have a direct exposure to supporting TBTF firms.

This deals with the how of regulating these firms. What are the implications for regulatory structure?

*Twin Peaks* proposed a Financial Stability Commission that would have “responsibility for the financial soundness of all major financial institutions”. However, the paper was ambiguous about the precise role and functions of the FSC: it has been variously interpreted as a single prudential regulator for all firms (whether or not systemically important) or as the prudential regulator of a sub-set of systemically important firms.

It should be clear from the above discussion of LCFIs and the systemic risk tax that the FSC should have the narrower mandate. Its purpose should be to apply the “tax” to a sub-group of financial institutions that are deemed “too big or too interconnected to fail”. Accordingly, its role would be as the regulator of institutions that sit at the core of the financial system and for this reason are bankruptcy-remote.

The Regulation by Objective principle points towards assigning this function to a stand-alone agency. The FSC should be given a clear mandate to apply the systemic risk tax and should be responsible for protecting the financial stability fund, with its performance as a regulator being assessed against the size and frequency of calls on the fund. Given that the financial stability fund would provide solvency insurance while the central bank provided liquidity insurance10, there is a case for having two separate agencies performing these roles. Combining the FSC with the central bank could result in the clarity of roles and responsibilities being lost.

Two other factors support the case for the FSC being a stand-alone agency. First, systemically important firms are no longer just banks but the broader category

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10. Although another possible use for the resources of the fund could be as a form of ELA.
of LCFIs. The expertise necessary to regulate all these kinds of firm does not traditionally reside in central banks. Central bankers tend not to be expert in insurance, or even in some of the more exotic capital market products. As Twin Peaks identified, a major problem for central banks is in finding a place for such specialists in organisations in which they will have few opportunities for career progression.

Second, given the importance of getting the regulation of systemically important firms right, it is essential that there should be some check and balance mechanism. Keeping the FSC distinct from the central bank will give both agencies an incentive to monitor each other’s performance and to identify trends and developments that require action. In addition, the central bank’s role in detecting system-wide risks will give it an important part to play in deciding which firms should be deemed systemically important and therefore regulated by the FSC. This judgment could be jointly determined by the FSC and the central bank. Building some creative tension into the system, rather than drawing a sharp dividing line between the agencies or subsuming the FSC into the central bank, seems the best way of ensuring that such checks and balances are in place.

Nonetheless, it has to be admitted that these arguments do not amount to a cast-iron case for keeping the FSC outside the central bank. On the other side of the ledger is the fact that there will be substantial overlap in the information needs of the central bank and the FSC. Anyone familiar with the ways of bureaucracy will realise that, even in the same building, information is not always readily shared; but it is certainly less likely to be shared between organisations. The UK’s Tripartite system has illustrated that even with the best intentions it is difficult to ensure adequate and timely information flows between agencies.

An additional factor is that locating the FSC within the central bank is likely to provide it with greater independence than it would enjoy as a stand-alone agency – provided that the central bank’s independence is not compromised. LCFIs are politically influential, and the application of the systemic risk tax is bound to be controversial. Lobbying for the tax to be reduced will intensify once memories of the crisis fade. Within the central bank, and thus enjoying an independent source of income, the FSC might be better able to withstand this lobbying pressure than if it remains a stand-alone agency dependent on an industry levy or a political vote of funds.

Given this balance of argument, the best arrangement might be to establish the FSC as a subsidiary of the central bank. They could be governed by separate, albeit overlapping boards, and enjoy common support services – for example a common IT platform and data warehouse that could be accessed by staff of both agencies. This would be similar to the relationship proposed between the ECB and the ESRB. The FSC’s staff might be central bank employees, thus permitting a degree of circulation between the central bank (especially its financial stability function) and the FSC. Under this arrangement, the Bank of England could remain the resolution authority while direct supervisory powers would be exercised by the FSC. Similar close institutional links have been adopted elsewhere in the world, for instance in France between the Banque de France and Commission Bancaire and between Finland’s central bank and Financial Supervision Agency. This proposed arrangement, involving agencies with distinct but partially overlapping mandates and strong institutional linkages, appears to offer the most effective combination of co-operation and checks and balances.
6. The regulation of non-systemic firms

Firms that are not LCFIs, or “non-systemic firms”, still need to be subject to prudential regulation of varying degrees of intensity, with attention focused on non-systemic banks and insurance companies. However, unlike LCFIs, non-systemic firms operate under a credible threat of bankruptcy. They are neither so large, nor so complex, nor so interconnected that they are beyond the effective reach of resolution techniques – for example, the transfer of part of their business (deposits, insurance contracts) to another, healthier firm. Prudential regulation in these cases exists to provide sufficient capital and liquidity buffers, so that the likelihood of a firm’s insolvency is reduced to some socially acceptable level. In addition, it helps to ensure that a non-systemic firm has sufficient reserves to make an orderly resolution feasible in the event that it ceases to meet minimum regulatory requirements.

Firms that adhere to the “plain vanilla” tasks of deposit-taking and lending, providing life or general insurance, or undertaking a broker-dealer function in liquid securities would not generally be subject to the systemic risk tax. These smaller, simpler firms can operate with proportionately lower capital and liquidity buffers than would be applied to LCFIs. The price of exemption from the systemic risk tax would be to accept regulatory restrictions on the scope of their activities and on their balance sheet size. In return, these firms would be subject to less onerous prudential requirements than those of LCFIs, reflecting the significantly lower externalities (spill-over effects) should they fail.

Although they should not have to contribute to the financial stability fund, they should nonetheless be required to pay into a compensation fund of their own. As its name suggests, that fund would provide depositors or policy-holders with compensation if a non-systemic firm, placed in liquidation, was unable to satisfy their claims. However, the resources of the fund should also be available to contribute to assisted merger or other resolution options, as is the practice with the FDIC in the US. LCFIs might also be required to pay into this fund to ensure that it has a sufficiently broad contribution base to build up a credible deposit insurance fund.

The non-systemic firms occupy the second circle of the scheme I described earlier – they are the firms of the inner periphery. However, the boundary between the inner core (regulated by the FSC) and these firms is not impermeable. If the systemic risk tax is effective, at least some LCFIs will have the incentive to downsize or simplify their operations. It is even possible to envisage a demerger trend in the financial industry comparable to that which led to the break-up of many industrial conglomerates in the 1980s and 90s. If this were to happen, these firms would move from the core to the inner periphery, and their prudential requirements would be adjusted accordingly. Conversely, a growing financial institution that breaches a

Small firms can operate with lower buffers
relevant trigger (see chapter 7) will find itself moving from inner periphery to core. Under this system, a bank that rapidly expanded its balance sheet, as Northern Rock did in the early part of this decade, would find that it became subject to more onerous regulatory requirements. It might even be deterred from growing to the point that it would become systemically important.

Firms of the outer periphery belong to a third category. They are not systemically important on an individual basis, although they have the potential to move as a herd and for this reason the central bank needs to keep their aggregate activities in its sights. Unlike firms of the inner periphery, the services they provide to their customers do not generally require substantial capital backing. Examples include asset managers and boutique advisory services. To the extent that these firms need a prudential regulator at all, it is a function that can be combined with regulating their sales practices.

Because the boundary between core and inner periphery is not impermeable, it might be thought that an efficient arrangement would be to have a single prudential regulator for both these categories of firm. If a firm either ceases to be systemically important (for example through balance sheet shrinkage) or reaches a systemically important scale, there could be a smooth transition from one department of the same regulator to another. This factor was influential with the Australian Wallis inquiry in recommending the single prudential regulator that subsequently became APRA (the Australian Prudential Regulatory Authority).

The chief disadvantage of this arrangement is that the purpose of identifying systemically important firms – to subject them to higher regulatory requirements and more intensive supervision – could potentially be diluted if they are regulated alongside non-systemic firms. As memories of the current crisis fade, the notion that systemically important firms require special attention might become harder to justify. A single prudential regulator might also be more likely to be influenced by level-playing-field considerations, and succumb to lobbying pressure to reduce the systemic risk “tax”. Moreover, the existence of two separate funds, with different purposes, also suggests that it would be desirable to have separate regulators, each charged with the responsibility of protecting “its” fund.

In the UK a single prudential regulator for both systemic and non-systemic firms has the additional disadvantage that it would require an axe to be taken to the existing institutional structure. This is the option that the Conservative party now proposes. However, if it is possible to achieve the same result with a scalpel this should be the preferred option, given the extensive disruption that setting up the current system has already involved. The idea of a separate prudential regulator for LCFIs has the advantage of transferring responsibility for only a relatively small number of firms to the new agency, leaving the FSA as the prudential regulator of firms in the inner and outer periphery.
Consumer protection

The FSA could also continue to discharge its functions as the consumer protection and market conduct regulator.

There is little to add to the extensive discussion of consumer protection regulation in the original *Twin Peaks* paper. One of the relative successes of the post-1997 regime in the UK has been to introduce much more clarity and transparency into the regulatory system from the point of view of the individual consumer. This was a major component of the argument put forward in *Twin Peaks* for a Consumer Protection Commission. This part at least of the *Twin Peaks* analysis was actually adopted in the UK. In the US, the Obama Administration is now looking to go down the same route with its proposed Consumer Financial Protection Agency. As noted in the original paper, there may be a case for a separate “peak” for market conduct regulation; but again, in the UK, an influential consideration should be the extent of the disruption to the existing regulatory structure with little direct benefit.

As consumer protection regulator, the FSA would oversee the sales practices of all firms. Firms in the inner and outer periphery would, therefore, continue to have the same regulator as now for both prudential and conduct of business matters. LCFIs with a retail franchise would be covered by two regulators: a prudential regulator (FSC) and a consumer protection regulator (FSA). This would no doubt lead to complaints of duplication and overlap, but should be treated as part of the “cost” of being a systemically important firm. It is especially important that the regulation of LCFIs should be subjected to multiple layers of oversight. As Mark Twain remarked, having put all your eggs in one basket, it makes sense to watch that basket.11

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7. Some objections

It is now time to consider possible objections to the proposed structure.

Those long in the tooth, or at least with long memories, might find vague echoes in these proposals of the “two tier” system of bank licences that the UK operated with limited success between 1979 and 1987. Banks were divided into “licensed deposit takers” (LDTs) and “recognised banks”— about which the standing joke was that the latter were run by people the Governor could recognise at cocktail parties. Because they were run by gentlemen, they could enjoy the lightest of light-touch regulatory regimes. The LDTs were, by contrast, the great unwashed of the banking world and subject to much closer supervision. Of course, when a problem did emerge – Johnson Matthey – it was at a recognised bank.

Any parallels between the former “two tier” system and the proposed structure are at best superficial. Whereas the 1979 Banking Act was designed to ensure that the City’s leading institutions did not suffer from intrusive regulation, the purpose of the current proposals is to ensure that all LCFIs are subject to higher requirements than non-systemically important firms. It is, in other words, the precise opposite of the former system, and has inbuilt incentives to ensure that the burden on systemically important firms is greater than the burden on those firms that are not systemically important.

A more serious objection is that it is notoriously difficult to define a LCFI other than by using the obvious criteria that it is large, complex and a financial institution. Identifying a sub-set of systemically important firms is therefore impossible, it is said, because systemic importance (like financial stability) has so far defied all attempts to define it. As Clive Briault argued in his “rationale” for the FSA in 1998, “the difficulty in determining which financial institutions might generate a significant negative impact on financial stability if they failed makes it difficult to draw a dividing line around which firms should be regulated by a separate ‘systemic’ regulator”.12

The answer to this argument is that the financial crisis has shown that we can tell, with a reasonable degree of assurance, which are the firms we need to worry about. The Obama administration’s White Paper on reform of the US regulatory system provides a good starting point by referring to firms that are “large, highly leveraged, and had significant financial connections to the other major players in our financial system”.13 Very large firms, no matter what their legal form, are clearly systemically important on any definition. Other, smaller firms might also be systemically important if they either provide a unique service (e.g. a firm that has a large share of the prime brokerage or tri-party agency business) or are highly interconnected. As argued in an intriguing recent paper by Andrew Haldane14, we should attempt

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to understand highly interconnected firms as nodes of a distributed network. Thus, the first step should be to map these networks and to establish which firms occupy strategic positions within them. Some initial steps are already possible in this direction, particularly since the same names keep turning up with some regularity in surveys of OTC markets conducted by bodies such as ISDA and the BIS. These firms should be considered systemically important because of their centrality to the financial system.

Thus, while we are still far from having a legally robust definition of LCFIs, the problem of definition is not insurmountable. A potential set of criteria for deciding whether or not a firm is a LCFI could include the following:

- firms with a consolidated balance sheet above some limit, whether in absolute terms, as a percentage of deposits, or perhaps as a percentage of GDP (as suggested by the Swiss National Bank);
- firms accounting for a minimum percentage of the activity in any particular market;
- firms that perform a unique or difficult-to-replace function within the financial system; and/or
- firms that surveys identify as playing a particularly interconnected role in the system.

Having defined LCFIs in this way, a second order question will be to decide whether they need to be licensed as “banks” irrespective of their legal form, or whether a new licence category of Systemically Important Financial Institutions (SIFI) should be created for them.

A third objection is that even if a robust definition of LCFIs could be developed, it would be undesirable to identify a sub-set of firms in this way. Several arguments can be put forward to support this point of view.

- Identifying certain firms as systemically important creates moral hazard. Some element of “constructive ambiguity” needs to be maintained concerning whether or not a particular financial institution could expect to receive support should it encounter difficulties. If management knows in advance that its institution is considered “systemically important”, any constraints on risk-taking will vanish.

- The definition of “systemic importance” varies according to context, so that even comparatively small firms can be systemically important if the circumstances are right. Barings – a medium-sized (for the time) merchant bank – is an example. It was possible for the Bank of England to allow it to fail in the relatively benign market conditions of early 1995; but in very
different conditions, with confidence already low, allowing the failure of a similar bank could trigger an adverse market reaction.

- A group of small, systemically unimportant firms can become systemically important through their collective behaviour. An example, again from Britain in the early 1990s, was the mini-crisis that swept through the small bank sector after the closure of BCCI. Heightened risk aversion cut off market access for these predominately wholesale-funded institutions. The Secondary Banking Crisis in the mid-1970s, where smaller banks suffered from a wave of failures, provides a further example.

The moral hazard argument can be quickly dispensed with. After decades of trying to maintain the fiction that the threat of bankruptcy potentially hangs over all firms, the authorities in the UK, US and several other countries have revealed their hand. The genie is out of the bottle, and now the only issue is how best to deal with a situation in which some firms know that they are too big to fail.

The argument that systemic importance is a function of circumstance remains important. If confidence is already fragile the disorderly failure of any firm could be enough to trigger widespread panic. But the lesson that should be drawn is that it is important to avoid the disorderly failure of an institution. As long as techniques are available to handle the orderly resolution or transfer of business of a troubled firm, what matters from the point of view of market and depositor confidence is the speed and efficiency with which these techniques are deployed. They can also be supported, where necessary, by policy action by the central bank to provide market liquidity. A serious problem arises only when the relevant techniques are not available to handle the orderly resolution of a financial institution – either because it is too large, too interconnected, or is active in too many different jurisdictions for conventional resolution methods to be available. As I have argued, these factors provide precisely the defining characteristics of the firms that should fall within the mandate of the FSC.

The third argument is that small firms can become systemically important if they move in the same direction at the same time, building up exposures to particular economic sectors (property development in the case of Britain’s secondary banks or the hedge funds’ movement into particular asset classes such as CDOs). But all this shows is that LCFIs are not the only source of potential systemic risk. They represent the core of the financial system, and for that reason need to be closely monitored and subject to the systemic risk tax. But systemic risk can arise from many other directions. Under the proposed structure, it will be the central bank’s responsibility (as part of its systemic risk function) to identify these risks wherever they arise.

A final point has been made against Twin Peaks from the very beginning. This is the claim that prudential and conduct of business (sales practice) regulation require examination of similar issues, and so there will be significant overlap between the Twin Peaks agencies. As Briault argued, both prudential and conduct of business regulation involve “a close and legitimate interest in the senior management of any
financial institution...because of the crucial roles of senior management in setting the ‘compliance culture’ of a firm, in ensuring that management responsibilities are properly allocated and cover comprehensively the business of the firm, and in ensuring that other internal systems and controls are in place”.

In short, a single regulator is superior to a Twin Peaks structure because many of the same supervisory judgments arise in both prudential and sales practice regulation. There seems little point in having two regulators reaching essentially duplicate judgments of broadly similar matters. Since there is substantial overlap between the two regulatory objectives, and in practice prudential and conduct of business regulation will focus on the same fundamental issues, they are best administered by a single agency.

Whatever the truth of this in the past, the crisis has created a very different perspective on this argument. The UK Government’s White Paper concludes that too much weight was placed on “conduct of business regulation of the banking sector rather than prudential regulation of banking institutions”, while the FSA’s senior management has conceded that the agency neglected prudential supervision. The House of Lords Select Committee on Economic Affairs has offered the following explanation for why the FSA failed to give sufficient attention to prudential regulation:

“Conduct-of-business is important and politically sensitive, and its results are easy to measure. In contrast, prudential supervision, while arguably more important, is conducted privately; its success is less easily measured, and, most of the time, it has a lower political impact than conduct-of-business supervision though in times of crisis such as the present its political impact, its effect on businesses, individuals and the economy, is very much greater than conduct-of-business supervision. It is natural and rational for a supervisor with responsibility for both activities to concentrate on the one with the greater immediate political sensitivity.”

In other words, the argument that there were synergies between prudential and conduct of business regulation overlooked the distinct possibility that one type of regulation would come to dominate within a single regulator, and that this was most likely to be consumer protection given the realities of the political process. Twin Peaks had predicted that this outcome was likely, and used it as one of the arguments against creating a single regulatory agency.

There is, therefore, a very strong argument for separating prudential and conduct of business regulation for all firms. However, it is also necessary to weigh several other

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15. Briault op.cit, pp.24-25.

16. The Turner Review; p.87: The FSA’s past regulatory practices resulted in “A balance between conduct of business and prudential regulation which, with the benefit of hindsight, now appears biased towards the former.”

factors: the disruption involved in completely dismantling the FSA; the ability of the FSC to concentrate on its core objective of regulating LCFIs; and whether a separate prudential regulator for non-systemic firms would be viable in the conditions of the UK (the US is a different matter). While the ideal would be a separation of these functions, on balance it seems less costly to leave the prudential regulation of non-systemic firms with the FSA. With the central bank performing its role in monitoring system-wide risks, the checks and balances of the system should help to mitigate the residual risk. However, this arrangement would also involve abandoning the notion – entrenched in the current Tripartite arrangements – that the Bank and FSA have equal status within their respective spheres. To ensure a counterweight to the risk that prudential regulation will again be neglected, the FSA would need to accept that the Bank/FSC are the senior partners in this relationship.

Under the proposed structure, only LCFIs would be subject to two regulators. Given their centrality to the financial system, these firms should view the resulting duplication as part of the cost of being too big to fail. It is inevitable that more than one pair of eyes is needed to monitor their activities. From the consumers’ point of view, however, the FSA will remain the main point of contact for issues that concern them. They would encounter the FSC only in the most exceptional circumstances, if at all.

Abandon the notion that the Bank and FSA have equal status
8. The international dimension

*Twin Peaks* ended with the suggestion that its proposed structure might help overcome the problem of international regulatory fragmentation, which was a big problem even in the mid-1990s. It envisaged a world in which countries with major financial centres each adopted a *Twin Peaks* structure, thus greatly facilitating their ability to co-ordinate oversight across borders. A system of specialist Financial Stability Commissions would, it was argued, address the problems of communication and consultation which even then were apparent in regulating large international firms.

Since then, much has been done to improve cross-border co-operation between regulators. They engage with each other to a vastly greater degree than was the case a decade or so ago. Developments in the pipeline, either regionally in the EU or internationally in the Financial Stability Board, should take this process to the next level.

Nonetheless, there is still good reason to believe that the adoption of the proposed *Twin Peaks* model in major financial centres would further enhance regulatory co-operation. Every large cross-border financial institution would then have a single prudential regulator in each of the jurisdictions in which it operated, and each regulator would have the same objectives. These prudential regulators would need to co-ordinate their application of the systemic risk tax to avoid harmful “tax competition” between jurisdictions. They might form a closely linked network of agencies all focused on the same goal. They might even develop common approaches to risk assessment and common examinations of cross-border firms.

An admittedly more utopian vision might be the eventual pooling of each country’s financial stability fund. The Financial Stability Commissions could agree that the funds raised under the systemic risk tax would be made available to their counterparts in other countries in the event that an LCFI encountered difficulties, on the model of central bank currency swap arrangements. Over time, a substantial pool of funds might be created for the bailout of LCFIs, thus helping to offset the possibility that the financial resources of one country might be insufficient to bail out its LCFIs. This notion is no doubt idealistic, but it may be more politically palatable for a dedicated bailout fund, contributed to only by large cross-border institutions, to be pooled in this way than funds that have been contributed by the taxpayers of each country.
9. Conclusion: The future structure of regulation

In the imagery used in the introduction to this paper, the proposed regulatory structure involves firms occupying one of three concentric rings, each with a different type of regulation and supervision of different intensities.

At the centre is a tightly regulated core of LCFIs. For prudential regulation, they fall within the ambit of the FSC; if one of them were to get into difficulty there would be a presumption in favour of it being bailed out. But they would pay a high price for this presumption in the form of higher capital and liquidity requirements and in contributions to the financial stability fund, which the FSC could use, in extremis, to provide capital or liquidity support to one of these firms.

The middle ring would be an inner periphery of other institutions, which would be regulated by the FSA on both prudential and conduct of business grounds. Prudential regulation would remain important for many of these firms, since they offer contracts that require capital backing, such as deposits and insurance. However, the size of these firms, or their degree of interconnection, would not preclude an orderly resolution. Since they are not systemically important, the presumption is that their failure would be handled through a resolution technique that protected the claims of their retail clients, e.g. through a purchase and assumption, bridge bank or similar type of transaction.

The final ring comprises an outer periphery of firms that do not individually pose a systemic risk, nor do they provide services that require capital backing; they include asset managers, smaller hedge funds, advisory boutiques etc. Insofar as they deal with retail consumers they should be subject to conduct of business rules imposed by the FSA, which would be the regulator of sales practices for all firms, including LCFIs.

The central bank would be the one institution with the ability to look across all of these concentric rings, identifying risks common to each and paying particular attention to the way in which these firms interact through a myriad of financial markets. It would have responsibility for the macroprudential surveillance of markets, with the associated responsibility for market infrastructure issues and the detection of system-wide risks. The central bank would need substantial information-gathering powers of its own to be able to perform this role. Its surveillance function should be backed by appropriate policy tools, although short-term interest rates would remain its main policy instrument. The FSC would be established as a subsidiary of the central bank.

There are three main points of difference between these proposals and those of the original Twin Peaks paper:
• First, the central bank’s financial stability role is more clearly defined. It should have an unambiguous financial stability mandate, the ability to gather information from a wide variety of firms and the policy tools to constrain risk-taking at an aggregate level. Its lead role as a crisis manager in most circumstances, except where public funds must be committed as solvency support, should be explicitly acknowledged.

• Second, the Financial Stability Commission is given a more precise mandate as the prudential regulator of LCFIs. Its primary responsibility is to impose the systemic risk tax through a combination of prudential requirements and contributions to the financial stability fund.

• Third, the Consumer Protection Commission is given a broader mandate. This does not merely include its original purpose of regulating the sales practices of all firms (including LCFIs) and market conduct, but also takes in the prudential regulation of firms in the inner and outer peripheries. It would be the successor organisation to the FSA.

The central concept in this structure is the systemic risk tax. By focusing on the case for the tax, I do not meant to imply that other regulatory measures are irrelevant. Other necessary components of a regulatory response to the financial crisis include a redefinition of regulatory capital, so that it can actually absorb losses on a going-concern basis\(^\text{18}\), and measures to reduce the incentives to excessive risk-taking created by remuneration structures. Nonetheless, from the point of view of the proposed institutional structure, what matters is the practicability or otherwise of the systemic risk tax. Like all taxes, it will no doubt suffer from problems of avoidance and evasion. Plus, LCFIs that are subject to this tax may be inclined to engage in greater risk-taking to compensate for the higher costs of doing business. For all these reasons, regulation of the LCFIs will need to be especially vigilant. If the tax cannot be applied effectively – and having a specialist regulatory agency for LCFIs seems the best way to achieve that – then it would appear that the only viable solution to the TBTF problem will be a legislatively-mandated separation of “utility” banking from the “casinos” (as proposed by John Kay in his recent report for the CSFI), with all that it would entail.

\(^{18}\) A major deficiency in the Basel definition of capital is that many instruments, such as subordinated debt, only absorb losses in the event of insolvency.
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Michael Taylor has unusually broad experience as a central banker, regulator and academic. At various points in his career he has worked at the Bank of England, International Monetary Fund and the Hong Kong Monetary Authority as well as having taught or held visiting appointments at a number of leading universities. While at the IMF he was closely involved in both the official sector response to the Asian financial crisis, including being based in Indonesia for two years as Financial Sector Issues Resident Representative, and to the Argentine financial crisis of 2001. He has served on a number of Financial Stability Forum or Basel Committee working groups. He is currently the Adviser to the Governor of the Central Bank of Bahrain.

In addition, Michael Taylor is the author or editor of many books, academic papers and journal articles, and is a regular contributor to *Financial World* magazine. His most recent publications include *Towards a New Framework of Financial Stability* (editor with Robert Pringle and David Mayes) and *Global Banking Regulation* (forthcoming from Elsevier). A measure of the success of his 1995 paper for the Centre for the Study of Financial Innovation, ‘Twin Peaks’: *A Regulatory Structure for the New Century*, is that it has become a standard point of reference in any debate on the institutional structure of regulation.
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