CSFI

“Twin Peaks”: A regulatory structure for the new century

by
Michael Taylor
The Centre for the Study of Financial Innovation is a non-profit think-tank, established in March 1993, to look at future developments in the international financial field - particularly from the point of view of practitioners. Its goals include identifying new areas of business, flagging areas of danger and provoking a debate about key financial issues. The Centre has no ideological brief, beyond a belief in open and efficient markets.

CSFI: Chairman of the Trustees, Minos Zombanakis; Chairman of the Governing Council, Sir George Blunden; Chairman of the Advisory Council, David Lascelles; Director, Andrew Hilton.
“Twin Peaks”: A regulatory structure for the new century
by Michael Taylor

Executive summary

This paper marks a further contribution by the CSFI to the mounting debate about the structure of financial supervision in the UK, a subject that will grow in topicality with next year’s tenth anniversary of the Financial Services Act.

Our earlier paper “UK financial supervision: a blueprint for change”, argues that the UK supervisory system had failed to keep up with the radical changes that were taking place in the financial service industry: the emergence of new types of investment banks combining traditional banking and stockbroking functions, the blurring of borders between markets, the new trading techniques facilitated by technology. We proposed a new Financial Services Commission to take over the regulatory roles of the Bank of England, the Building Societies Commission and, over time, other regulatory bodies, as a professional, statutory, purpose-designed body.

This paper takes the debate a stage further by arguing that supervision/regulation has essentially two aims: to ensure the soundness of the financial system, and to protect consumers from unscrupulous operators. These aims, which often conflict, are not adequately separated in the present regulatory set-up with the result that they give rise to confusion and damage. For example, it is not clear whether the Bank of England’s primary role is to look after the financial system, or to protect depositors. Furthermore, the consumer protection side is now so fragmented that the ordinary investor does not know where to turn.

Michael Taylor, formerly with the Bank of England and now director of a course in financial services regulation at London Guildhall University, proposes that the regulatory system be redesigned around the twin peaks of systemic protection and consumer protection. The first peak, the Financial Stability Commission, would ensure that there were adequate prudential measures to ensure the soundness of the system, the capital adequacy of banks and control of risk. The second, the Consumer Protection Commission, would enforce conduct of business regulation to ensure that the consumer received a fair and honest service.

The twin aims would be implemented by two separate regulatory bodies, but nonetheless ones with closely overlapping staff and governing boards, both answerable to the Treasury. If a conflict arose between the two, as might well be the case, this would be resolved politically at ministerial level in the Treasury.

Taylor argues: "The benefits of twin peaks are clear. The proposed structure would eliminate regulatory duplication and overlap; it would create regulatory bodies with a clear and precise remit; it would establish mechanisms for resolving conflicts between the objectives of financial services regulation; and it would encourage a regulatory process which is open, transparent and publicly accountable. As such, it is consistent with the current philosophy of ' unbundling' the functions of public sector agencies, to achieve greater transparency, efficiency and clearer lines of responsibility. In all these respects, it marks an advance over the existing institutional structure".
Introduction: The need for change

Britain’s system for regulating financial services, as was once said of its Empire, has been acquired in a fit of absence of mind. This paper proposes a radical restructuring of that system to give it greater coherence, as well as to align it with the realities of today’s financial marketplace. It argues for the consolidation of the existing multiplicity of regulatory bodies into two financial commissions, one responsible for the stability of the financial system as a whole, and the other responsible for the protection of the private, retail investor. These are the “twin peaks” of the paper’s title.

As a radical option for change, the twin peaks model was first mooted in the CSFI pamphlet *UK Financial Supervision: A Blueprint for Change*.

The earlier paper suggested, however, that this model might be too radical to gain acceptance and therefore advanced the case for a more modest organisational change involving the merger of the Bank of England’s banking supervisory functions with the Building Societies Commission in a stand-alone body, the Financial Services Supervisory Commission.

Since the publication of *A Blueprint for Change*, however, the regulatory debate has moved a considerable distance. Taken in combination, the issues raised by the Barings episode, the tensions between the SIB and its front-line regulators, and convergence in the capital adequacy regimes applied to banks and securities firms resulting from the implementation of the EC’s Capital Adequacy Directive, amount to a powerful case for considering whether structural reform of regulatory system might not now be a necessity.

Against this background the Treasury and Civil Service Select Committee has called in its recent report for a wide-ranging review of regulation, including a review of the role of the Bank of England in banking supervision. Although the Committee stops short of recommending a radical restructuring of the system of regulation, it does make the important observation that there is an increasing mismatch between regulatory structure and market reality. The proposals outlined in this paper represent a possible way ahead for the regulatory system, given the emerging structure of the financial services industry.

The purposes of financial services regulation

In assessing the present regulatory framework, it is helpful to begin by considering the public policy objectives in the regulation of financial services. These may be broadly described as being:

- 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”).

---

The first objective translates into prudential measures designed to ensure the financial soundness of institutions — including capital adequacy and large exposures requirements, measures relating to systems and controls and provisioning policies, and the vetting of senior managers to ensure that they possess an appropriate level of experience and skill. In contrast, the second objective is primarily promoted by "conduct of business" measures designed to ensure that individual consumers are not the victims of fraud, incompetence or the abuse of market power. These measures include, for example, detailed rules governing the advertising, marketing and sale of financial products, as well as the registration of individual salespeople who are also required to meet certain minimum standards of integrity and competence.

It should be noted, however, that the distinction between "prudential" supervision and "conduct of business" regulation does not precisely parallel the distinction made between the systemic and consumer protection goals of regulation. For example, prudential requirements can (and do) serve to protect the interests of depositors, as well as to help protect the financial system as a whole from disruption. Nonetheless, these objectives are analytically distinct, and they provide useful organising principles for thinking about the structure of financial services regulation.

The existing system assessed

The present system of financial services regulation in the UK — covering banking, securities, investment management and insurance — has been created by a series of piecemeal responses to specific events or to fill perceived gaps. The twin objectives of financial services regulation have been parcelled out among a multiplicity of agencies, and there has been little attempt by policy-makers to consider the interrelationship of the various components of the system, or the extent to which these agencies might possess overlapping or conflicting objectives. Although these shortcomings have been inherent in the system for some time, recent developments have further exposed the extent to which the regulatory system is fragmented, lacks clear public accountability, and looks increasingly ill-attuned to the realities of financial services business as it is likely to be conducted into the next century.

Systemic protection

*A Blueprint for Change* identified two fundamental shortcomings in the existing arrangements for the supervision of deposit-taking institutions.

First, it noted that the current statutory framework relating to the supervision of banks creates a potential conflict between the Bank of England's responsibility *qua* central bank for the soundness of the financial system and its perceived role in protecting the consumer. Since the Banking Act assigns the Bank an explicit remit to protect the interests of depositors, it only succeeds in creating confusion over what the purpose of banking supervision is supposed to be, and it creates a mistaken public perception that deposits are guaranteed by the Bank. The consumer protection aspect of the Banking Act in fact serves to obscure what should be the primary objective in the supervision of banks — the protection of the financial system as a whole from disruption.

Secondly, *A Blueprint for Change* also noted that the existence of separate supervisory arrangements for banks and building societies appears increasingly anomalous. The paper argued that the banking and building society industries already
have very similar interests, are subject to institutional supervision, and compete head-on in the High Street for many of the same customers. In addition, the differences in regulatory regime between banks and building societies are gradually being eroded by deregulation, while the larger societies are arguably now more systemically important than many banks. Although market forces may already be taking a hand in the matter, as a number of the larger societies are either acquired by banks (as in the case of the Lloyds take-over of the Cheltenham and Gloucester) or opt for demutualisation (as has the Halifax), the existence of a separate regulatory body for mutual institutions which are increasingly taking on many of the characteristics of joint-stock banks does seem hard to justify in strict logic. For this reason A Blueprint for Change proposed the creation of a Financial Services Supervisory Commission which would bring the supervision of all deposit-taking institutions under one roof.

However, the merger of responsibilities for the supervision of banks and building societies goes only a limited way towards addressing the fragmentation of systemic protection regulation. There is now a powerful case for assigning responsibility for the financial soundness of all major financial institutions to a single agency which would be explicitly charged with protecting the financial system as a whole from disruption. This case has four main components:

- a wide range of financial firms must now be regarded as systemically important;
- existing regulatory requirements raise issues of competitive equality between types of financial firms;
- the rise of financial conglomerates makes a group-wide perspective -- covering banking, securities, and insurance -- essential; and
- finally, there is a need to pool the rare expertise which is necessary adequately to supervise increasingly sophisticated trading operations.

Banks have traditionally been seen as the key systemically important institutions. However, as the Promisel report of 1992 observed, a wide range of financial firms can now create potentially systemic problems, given the importance of non-bank financial firms -- securities houses, insurance companies, trusts and others -- in the OTC ("over-the-counter") derivatives markets, including as market makers in some cases. Thus, the emergence of the OTC derivatives markets, in which both banks and non-bank financial firms are active players, makes it more likely that the failure of a non-bank financial institution could damage the broader financial system. For instance, in contrast to securities houses' traditional investments, derivatives contracts are not highly liquid and may be difficult to unwind in an insolvency. Thus the failure of a securities house which is a major player in these markets may itself be the cause of systemic risk through disruption of the payments system. Serious problems were avoided in the case of Drexel Burnham Lambert, a securities house with a large swaps book; but this is no reason to assume that the same would be true in future. Insurance companies are now also moving into the OTC derivatives markets -- with similar potential for systemic disruption resulting from the failure of a company which has become a major player in these markets.

The quantum of risk in the financial system may not have been increased as a result, but it has been distributed across a wider range of financial firm. Thus, although

---

3 Recent Developments in International Interbank Relations ("The Promisel Report"), Basle, October, 1992.
derivatives may not themselves contribute to enhanced systemic instability, the rise of the OTC markets means that we must extend our concept of what constitutes a systemically important firm.

The fact that banking, securities, and insurance companies are now interlinked in ways which were unanticipated when the existing regulatory system was devised provides a powerful reason for eliminating the present division of responsibility for ensuring their prudential soundness. As the Cross report observed, there is a case "for reducing the potential failure of large non-bank financial firms by extending bank-like regulation and supervision to them, even though they do not take deposits from the public and would not fit under the particular supervisory standards applicable to banks". In other words, the supervisory and regulatory response to the development of the OTC derivatives markets has been the catalyst to bring the regulatory regimes applied to banks and securities companies into line -- at least to the extent that these financial intermediaries are now active in the same markets and incur the same risks. This convergence of regulatory standards, which might eventually embrace even insurance companies as well, strengthens the case for their application by the same regulatory body.

The preceding point relates to the concern of policy-makers to ensure that the regulators are able to provide adequate oversight of the financial system. However, from the point of view of the regulated firms, there is already an important issue of competitive equality arising from the convergence of the capital adequacy regimes applied to banks and securities houses.

Following the implementation of the EC's Capital Adequacy Directive, both banks and securities houses will be subject to the same capital requirements to the extent that they engage in the same activities. Given that securities firms and banks are competing in the same markets, and are increasingly subject to the same capital adequacy regime, the case for them having separate regulatory bodies is correspondingly diminished. Indeed, the existence of separate regulators, each interpreting the CAD in a slightly different way, must generate concern on the part of financial institutions about the equality of treatment between different categories of financial firms. It may also make "regulatory arbitrage" more likely, with financial conglomerates able to book transactions in the entity with the most favourable regulatory regime.

The Barings episode provided a graphic illustration of the risks associated with the rise of financial conglomerates, which have been defined by the recent report of the Tripartite Group of Banking, Securities and Insurance Regulators as "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)". In the Barings case, the bank in the group failed as a direct result of losses incurred by a futures trading subsidiary, but even with "firewalls" and other mechanisms in place to "ring-fence" the bank, financial conglomerates can give rise to a new kind of contagion risk, which is based on not direct exposures between group companies but on the market's perception that they are linked. The Tripartite Group's report described this as "psychological contagion -- where problems in one part of a

---

group are transferred to other parts by market reluctance to deal with a tainted group...”.6 Depositors with the bank, both wholesale and retail, can often respond adversely to problems in another group company simply on the strength of the commonality of name.

The reverse side of this development, however, is that the more sophisticated diversified financial groups are increasingly seeking to manage and assess their risks on an integrated basis. It can only be a matter of time before supervisors are forced to follow suit, and the Tripartite Group’s reference to the need for a “group-wide perspective” to the supervision of financial conglomerates if such supervision is to be effective7 is recognition that prudential soundness and risk management can no longer be understood by focusing exclusively at the level of the individual firm.

Of course, solo supervision also remains essential, and hence different prudential regimes will continue to be necessary for banking, securities, and insurance. But it is worth considering how the requisite “group-wide perspective” can best be achieved. At the very least, more co-operation between regulatory bodies will be necessary, but it may be that only the integration of prudential supervision to reflect the integration of financial groups themselves will be sufficient in the longer term.

A final consideration also derives from the increased emphasis on assessing the adequacy of the internal risk control systems (including value-at-risk models) and the need to understand the global risk profile of complex financial groups.8 This is already creating a demand for high levels of expertise on the part of supervisors and regulators—a demand which is likely to expand still further in the coming years. Given the inability of the regulatory bodies to compete with the remuneration offered by the commercial sector, this expertise is always likely to be in short supply. Thus, there is a strong case for pooling the presently thinly-spread regulatory expertise to undertake the difficult task of adequately supervising sophisticated risk management systems and to develop the techniques necessary to come to grips with the issues posed by financial conglomerates.

These four considerations suggest that there is now a strong case for bringing the prudential supervision of banking, securities, and insurance within the ambit of a single regulatory agency. However, the present regulatory system is premised on a compartmentalisation of function and of risk, with the result that a wide range of regulatory bodies might at present be able to stake a claim to an interest in systemically important firms. These bodies include the Bank of England, the Building Societies Commission, the Department of Trade and Industry, the Securities and Investments Board, and the Securities and Futures Authority. While a number of initiatives have been made to overcome this fragmentation of responsibilities (for example in the form of the College of Regulators and—post-Barings—joint visits by the Bank of England and SFA), it is doubtful whether the basic institutional structure represents either a logical or efficient arrangement. Recent trends in the financial markets, in the structure of financial groups, and in regulatory policy suggest that a single financial services supervisor which would be responsible for the overall stability of the financial system is now a necessity.

---

6 The Supervision of Financial Conglomerates, p.18.
7 The Supervision of Financial Conglomerates, p. 65.
8 Especially important is the Basle Committee’s adoption in principle of value-at-risk models for calculating a bank’s capital requirement in respect of market risk. See An Internal Model-Based Approach to Market Risk Capital Requirements, Basle, April, 1995.
Consumer protection

The regulatory system is almost as fragmented in the pursuit of the consumer protection objective as it is in the supervision of systemically important firms.

Although the formation of the FSA has consolidated retail regulation to some extent, by removing the split between LAUTRO and FIMBRA, it remains the case that the consumer protection objective is pursued by a number of other bodies -- the SFA (private client stockbrokers and futures firms), IMRO (investment managers), the recognised professional bodies, and the various Ombudsman schemes. In addition, the position of the Office of Fair Trading in administering the Consumer Credit Act is often overlooked in discussions of financial services regulation, despite the fact that it is a fundamental component in the system of consumer protection. Finally, the consumer protection role assigned to the Bank of England by the current Banking Act has already been mentioned, and it is likely that the conflicts of interest this creates would be accentuated if deposit-based products were to be subject to a similar sort of conduct of business regime to that already applied to investments.

The argument for maintaining the present multiplicity of regulatory bodies relies on the different levels of investor protection which are appropriate for different types of investment.

The purpose of investor protection is to ensure that individuals have the necessary information to be able to make informed investment decisions, taking into account the costs and risks of the investment. The extent to which the individual consumer is in need of this type of protection will, obviously, vary according to his or her degree of sophistication, and also according to a number of other factors -- including the nature of the financial product under consideration, the proportion of an individual’s capital being committed to the transaction, and the extent to which there is scope for repeat transactions, enabling the individual to gain in knowledge and experience. At one end of this spectrum, the purchase of shares in a FTSE 100 company is arguably little different from the purchase of a major consumer goods item, an activity in which caveat emptor is allowed to prevail. By contrast, subscribing to a personal pension plan is more likely to be a once-in-a-lifetime decision, representing a substantial proportion of the individual investor’s capital, with few opportunities for repeat purchases, and with an uncertain final outcome which may be as many as thirty years in the future.

The existence of this spectrum represents probably the strongest argument for maintaining the current multiplicity of regulatory bodies. It can plausibly be argued that the level of consumer protection required for the purchase of shares and the level of protection required for personal pensions are so different that the respective regulatory regimes should be administered by quite separate bodies. On the other hand, this fragmentation of effort is not ideal from the point of view of consumers, many of whom are confused by the present “alphabet soup” of regulatory bodies. This difficulty is enhanced when, as is often the case, a financial firm is a member of more than one SRO. Moreover, the existence of a multiplicity of regulatory bodies makes it more likely that important issues may disappear down the gaps, especially when the boundaries between their responsibilities are unclear. Thus, although it has to be recognised that the regulatory regime appropriate to the marketing of personal pensions differs from that appropriate for a private client stockbroker, this distinction could be as well captured by different operating divisions of the same regulatory body as by entirely separate institutions.
Shortcomings of self-regulation...

...will become increasingly evident

Self-regulation works best when the participants to a transaction possess approximately equal knowledge, information and bargaining power, as occurs for example in most interprofessional markets. But transactions involving a professional dealing with a retail client do not, almost by definition, satisfy this condition. It would therefore seem no coincidence that the present system has appeared in the past to be most ineffective in delivering consumer protection in relation to complex and opaque mass-marketed products, where the inequalities of knowledge and information are especially acute. The pensions mis-selling episode, and the life assurance industry's foot-dragging over commission disclosure, tend to confirm that self-regulation was probably never an appropriate mechanism for delivering investor protection in this sector of the industry. While the present system has delivered more effective investor protection in relation to other types of investment product, it probably is not feasible to abandon self-regulation for some classes of retail investor and not for others.

Planned future developments, involving an extension of the principle of private provision of social insurance (for example, unemployment protection for mortgage-holders), mean that the existing structure of regulation may be placed under considerable strain as the dividing line between those products which are and those which are not covered by the existing arrangements comes to appear increasingly arbitrary. In addition, these developments mean that regulation of retail products can be expected to be subject to much more intensive political scrutiny. As the Treasury Select Committee noted in its report, "At a time when welfare reforms are likely to see greater calls on the private sector to provide varieties of savings and investment products and social insurance it is vital that the Government gets the financial system right now".9

The lack of accountability of the present system is in part the product of the "two tier" structure in which the SROs conduct day-to-day regulation and SIB acts as the supervisor of the regulators.

Those charged with administering the system argue that the line of accountability of SRO to SIB and SIB to the Treasury (and hence to Parliament) is unambiguous; but a system with so many layers means that responsibility can become diffused in particular cases. Moreover, an important component in the original vision of "self-regulation in a statutory framework" was that the regulatory bodies would be responsible to their members, thereby creating an incentive for them to avoid the excessive levels of regulation which were allegedly associated with a government commission. This principle seems to have been abandoned during the creation of the PIA, which has a board without a majority for its industry members. The structure of the PIA's board is implicit recognition of the failings of self-regulation in at least some areas of investor protection, but this has created a regulatory agency without clear lines of public accountability.

The final consideration is that the present system suffers from a lack of clear objectives, a point exemplified in at least two ways:

- The Financial Services Act's regulators are responsible for monitoring compliance with prudential as well as conduct of business requirements. The Financial Services Act has created a regulatory system for the protection of the individual investor, the key to which is the various "conduct of business"

9 The Regulation of Financial Services in the UK, p. xii.
The FSA confuses its role...

requirements relating to the way in which products can be marketed and sold. By contrast, prudential requirements are less important for investor protection. Provided that clients' assets are segregated from those of the firm, and that proper accounting and transaction records have been maintained, a client is placed at very little risk from the failure of the firm, and at worst should suffer only the inconvenience of a delay in obtaining his or her assets. Capital requirements are therefore of doubtful relevance for stockbrokers and investment managers, and are even more anomalous for investment advisers who do not hold client funds. Nonetheless, the Financial Services Act's regulators, most notably the SIB and SFA, have also become involved in regulation which has a primarily systemic protection remit. Much of the SIB's work in international fora - for example its participation in the Technical Committee of IOSCO - should appear under this rubric, while the SFA is directly responsible for the regulation of the securities houses which (as was argued earlier) are now of systemic importance. Not only does this result in the fragmentation of responsibilities discussed in relation to the systemic protection objective, but it arguably also obscures the primary objective of the Financial Services Act regime, the protection of the individual investor.

- The Financial Services Act applies to the interprofessional markets, obscuring the fact that its primary purpose should be the protection of the retail investor. The purpose of consumer protection, it must be emphasised, is to protect individual investors, depositors and policy-holders to the extent that they cannot reasonably be expected to protect their own interests. There will always be scope for dispute about the boundary between those investors who can, and those who cannot "reasonably" be expected to protect their own interests, but few would argue that participants in the interprofessional markets are unable to take care of themselves. A good deal of the initial hostility to the Financial Services Act was due to the application to the interprofessional markets of conduct of business requirements designed for the retail consumer, thereby creating an unnecessarily burdensome level of regulation. It is essential from the point of view of maintaining London's position as an international financial centre that the interprofessional markets are subject to a benign conduct of business regime, and that measures designed to protect the domestic, retail consumer are not be applied to them by default. In recent years a good deal of progress has been made in disapplying rules in these markets, but this process has been carried about as far as is possible under existing legislation. It would be more appropriate for the code of conduct concept, already successfully in use in the Bank of England's Grey Paper regime, to be extended to interprofessional dealings in all types of financial instruments. This would have the benefit of reducing the regulatory burden on the wholesale markets and making clear that the primary objective of the FSA should be the protection of the private, retail client.

The problems with the existing regulatory system may, therefore, be summarised as:

- excessive fragmentation, particularly in relation to the systemic protection objective, but arguably in the case of consumer protection as well;

10 Notwithstanding cases like Proctor & Gamble vs. Bankers Trust in the United States, there is a strong case for leaving the protection of the interests of major corporates to the normal processes of commercial law. Hence, they may also be regarded as "professionals" for these purposes.
- a lack of accountability, either to parliament or (increasingly) to the industry, which is compounded by a complex and fragmented regulatory structure; and

- a lack of clarity in the objectives of the existing regulatory bodies, which in some cases pursue both systemic and consumer protection goals, and which are unable to make sufficient distinction between the needs of the retail and wholesale markets.

What does this mean for a new institutional structure?

The reconfiguration of the present institutional structure of regulation around the two main objectives of regulation — systemic protection and consumer protection — will go some considerable distance to resolving these problems. In terms of specific institutions, the proposal is to create two regulatory commissions:

- a Financial Stability Commission; and

- a Consumer Protection Commission

The Financial Stability Commission (FSC) would operate with an explicit systemic protection remit.

It would be responsible for the authorisation and on-going prudential supervision of all major financial institutions (banks, building societies, securities houses, and insurance companies), on both a solo and a consolidated group basis. The Commission would thus have oversight of all institutions from which a potentially systemic crisis might originate, and would be well placed to monitor the activities of diversified financial conglomerates.

The structure of the FSC would be similar to that proposed for the Financial Services Supervisory Commission in A Blueprint for Change, with the addition of those parts of the Securities and Investments Board and the Securities and Futures Authority which are responsible for policy and for the regulation of the “multi-product firms” (i.e. the major securities houses). There is also a strong case for bringing the prudential supervision of insurance companies with the FSC’s ambit. The objective of the FSC would be to prevent widespread systemic disruption; although it should be noted that this is not equivalent to preventing the failure of any particular firm or financial group.

The Consumer Protection Commission (CPC) would take over the consumer protection role currently discharged by the various Financial Services Act regulators, primarily as it relates to conduct of business in the retail markets. In time, it might also take over the administration of the Consumer Credit Act and would subsume the various Ombudsman schemes.

Since, as already noted, the appropriate level of investor protection varies according to the nature of the investment, the CPC would contain a number of operating divisions, comprising as a minimum:
private client stockbrokers;
- futures firms;
- investment managers; and
- packaged products (i.e. life assurance and unit trusts).

In contrast to the existing multiplicity of regulatory agencies, these divisions would operate within a common management structure, under the overall direction of a single Commissioner. The advantage of a common management structure is that it would provide a much stronger mechanism than at present for avoiding damaging turf battles and for assigning regulatory responsibilities for financial products which do not fit readily into the established lines of demarcation. Nonetheless, these various operating divisions might — initially at least — continue to employ substantially the same rulebooks as the existing SROs, thereby reducing the immediate costs of change from the point of view of the regulated firms. In the longer term, this model would offer scope for cost savings as a result of rulebook simplification. Authorisation from the CPC would only be required of those financial firms which deal direct with the retail consumer, who in turn would enjoy the benefit of a "one-stop shop" in the case of a complaint against a regulated firm. Activities in the interprofessional markets would not be subject to authorisation by the CPC. Conduct of business in these markets would instead be governed by a Code, similar to the Grey Paper regime, which would be administered by the FSC.

It should also be noted that both Commissions would have the power to authorise financial institutions.

An authorisation from the FSC would only be recognition that an institution met certain minimum standards of prudential soundness, and would not permit it to deal direct with the retail consumer. For the latter, an authorisation from the CPC would be necessary, permitting a financial institution to provide certain specified services or products to the retail consumer (like the authorisations now conferred by the SROs). Whether or not deposit-taking will be subject to this "dual key" approach will largely depend on whether conduct of business rules are extended to cover deposit-based products. Even if this were to be the case, it would nonetheless be possible to create a new category of "wholesale banks", which would be exclusively funded by borrowings on the wholesale markets, and which would only be subject to supervision by the Financial Stability Commission.

Governance and staffing of the Commissions

A Blueprint for Change recommended that the Financial Services Supervisory Commission should be a Crown body, established by Act of Parliament, and headed by a Parliamentary Commissioner who would be directly accountable to Parliament. There is a good deal to be said for adopting this proposal in the "twin peaks" model, as ensuring the maximum degree of accountability for the discharge of the Commissions' respective responsibilities. On the other hand, direct accountability to Parliament would represent a constitutional innovation and arguably makes the politicisation of regulation more likely. Thus there is a case for making the Commissioners responsible to the Chancellor of the Exchequer in the first instance, and through him to Parliament. This would have the added advantage of enabling HM Treasury to act as a bridge between the two peaks.

The Commissioners must be supported by strong boards with wide experience both of financial services and of public life. In the case of the FSC, the board should comprise...
...helped by experienced boards with overlapping memberships

representatives of HM Treasury and the Bank of England, as well as senior figures from the banking, securities, and insurance sectors of the industry, and a number of public interest representatives. The board of the CPC would require a similar balance between public service, industry, and public interest members, although it would be right for the latter to exercise a comparatively greater (although not dominant) influence on the board to reflect the CPC’s explicit consumer protection role. To enhance co-operation between the Commissions, membership of their boards should overlap to some extent -- for example with the Financial Stability Commissioner serving on the board of the CPC, and vice-versa. Membership of the boards would be for a five-year term, on the recommendation of the relevant Commissioner, and would be a Crown appointment.

Each Commission should also be advised by a number of technical committees, comprising industry representatives with specialist knowledge of the relevant area of the industry. This would help ensure continuing practitioner involvement in the policymaking process, which is widely regarded as one of the most valuable features of the existing system.

Each Commission should be responsible for recruiting its own staff, since the knowledge and expertise they will require will be markedly different. The staff of the Financial Stability Commission will need to have (or to acquire) the skills used by auditors and risk management specialists, and should include at least some with the mathematical background to be able to understand and assess the most advanced risk management models. By contrast, the Consumer Protection Commission will require staff with a predominately legal or accounting background, including at least a few who are skilled in forensic accountancy. This contrast in skills is already apparent within the regulated firms themselves, where risk management specialists and compliance professionals are involved in different aspects of regulation (prudential and conduct of business respectively).

The "twin peaks" model may help address the problems of recruitment and retention experienced by all the regulatory agencies at present, although it has to be acknowledged that these do not admit of simple solutions.

The need is to encourage the development of a cadre of well-trained, professional regulators. One difficulty at present is that each of the existing agencies has an average of only a little over 200 staff, which makes them too small to offer clear scope for staff development and progression. By contrast, the Commissions will each be sufficiently large to provide a challenging career path to their employees, including the opportunity for moves between divisions and departments to gain a broader knowledge base. In addition, the attraction of a career in regulation will be enhanced by the prestige which will undoubtedly be attached to an institution wielding considerable clout in the financial marketplace. While comparative levels of remuneration will always remain problematic, the attraction of spending part of one’s career in a powerful institution with a strong professional ethos should not be underestimated.

Staff remuneration is also closely linked with the funding of the Commissions. If they are to be funded by a levy on the regulated industry, as was proposed for the Financial Services Supervisory Commission in A Blueprint for Change, and as is currently the case for the Financial Services Act regulators, the agencies will be freer to set the remuneration of their staff than if they are funded directly by government, with the constraints this inevitably entails. In addition, funding by a levy has the added advantage of securing greater independence from government in other respects,
thereby reducing the danger that regulation becomes politicised, and it ensures that the costs of regulation fall directly on those who are intended to benefit from it. On the other hand, without the counterweight which industry involvement provides in the present self-regulatory arrangements, it will be all the more important to ensure that the costs of regulation are as transparent as possible, including to the consumers it is intended to benefit.

Relationship between the FSC and CPC

In principle, there is a clear division of responsibility between the two Commissions.

The FSC will be responsible for ensuring the stability of the financial system as a whole through its prudential supervision of banks, building societies, securities houses, and insurance companies. The CPC, by contrast, will be concerned with the way in which specific products are sold and marketed to individual investors, policy-holders (and perhaps ultimately depositors).

This division of responsibilities replicates, to a significant degree, the prudential/ conduct of business split which has already been well established between the DTI and PIA in the regulation of insurance companies.

Nonetheless, there are a number of instances in which close co-operation between the Commissions will be essential. In particular, since both Commissions will have powers of authorisation, it will be important to ensure that they co-ordinate the use of these powers. For example, the CPC might be keen to close down an institution for a particularly serious breach of its rules, whereas the FSC might feel that to do so would run the risk of creating systemic instability. There are a number of other ways in which action taken by one of the Commissions may impact adversely on the interests of the other; as the pensions mis-selling episode illustrates, sufficiently grave problems arising from conduct of business issues can ultimately impact on the prudential soundness of the institutions concerned. Hence, close co-ordination of policy will also be required. In addition, policing the boundary between wholesale and retail transactions will be a difficult area, and therefore it is important that the boundary line should be as clear and unambiguous as possible (a measure based on transaction size, as is now used in the wholesale money markets, would appear to offer the simplest solution).

H.M. Treasury will have an essential role to play in ensuring a co-ordinated approach by the two Commissions, and in the last resort will have to act as the arbitrator in disputes between them. However, mechanisms can also be created to attempt to forestall the possibility that disputes would become sufficiently serious to be raised at Treasury level. These might include joint committees of the two Commissions, at both staff and board level, within which areas of mutual interest can be explored, and potential conflicts of interest resolved. Staff exchanges and secondments, and overlapping membership of the boards of the two Commissions, will also go some way to reduce the scope for uncoordinated actions.

The role of the Bank of England

Although the functions of the FSC could be performed by the Bank of England, the Commission should be independent of the Bank for reasons already outlined in A Blueprint for Change. As the once-clear demarcation lines between types of financial
markets and institutions are broken down, the Bank’s role appears increasingly anomalous, and there is also a need to disentangle the conflicting interests which currently exist within the Bank -- which are likely to become more acute if it eventually wins greater autonomy in the conduct of monetary policy.

On the other hand, the FSC will need to have close links with the Bank, particularly in the formulation of policy, and this will be achieved in part through Bank representation on the board of the Commission.

A Blueprint for Change observed that one of the most troublesome areas in redesigning the regulatory system concerns the Bank’s role as lender of last resort (LLR).

This function takes two forms: the first, which is the role of LLR as it was understood and first described by Walter Bagehot, is as a provider of general liquidity to the market. There is no reason why the Bank should not continue in this role under the “twin peaks” structure, but LLR has also subsequently come to mean the provision of support to particular troubled institutions. It would obviously be inappropriate for the Bank to underwrite a system over which it lacked supervisory control, and moreover the “twin peaks” model extends the concept of systemically important firms beyond the presently recognised boundaries to institutions with which the Bank has never had a formal relationship. Since the FSC will clearly lack significant financial resources of its own, there is a strong case, as A Blueprint for Change argued, for vesting the LLR function in the Bank as an agent of government; this would mean providing the Bank with an indemnity from the Treasury for the support funds it provides. The Treasury would therefore need to be closely involved in any decision to provide LLR support, although it would act on the advice of the FSC and the Bank.

A third “peak”?  

As part of its consumer protection objective, the Financial Services Act is also concerned with ensuring that markets are orderly and “clean”, i.e. free from deliberate manipulation or from the exploitation of insider information. The charge of regulatory fragmentation applies especially clearly in relation to this objective: in addition to SIBs and the SROs, other relevant agencies include the Exchanges, the Department of Trade and Industry, the Serious Fraud Office, the Crown Prosecution Service and the Police.

Within the “twin peaks” framework, the CPC might take on the market surveillance and supervision role; but there are substantial differences between the expertise and skills required for this function and for conduct of business regulation. Thus, there is a case for a third “peak” – a Market Surveillance Agency (MSA), charged with oversight of all London’s financial markets, particularly from the point of view of detecting and prosecuting various forms of market abuse.

It would also be worth considering whether the MSA should be able to pursue its prosecutions according to a civil standard of proof and using civil rather than criminal penalties. In addition, if the Stock Exchange’s position continues to be eroded by the emergence of competing service providers, its company listing function may soon come to appear increasingly anomalous, and this might be transferred to the MSA. A body with these functions and powers would be a much closer British analogue to the US Securities and Exchange Commission than any of the existing regulatory bodies, and would be similar to the “City Policeman” first mooted by Andrew Large in his report on Making the Two Tier System Work.
Why not a single Financial Commission?

While “twin peaks” would rationalise the existing system of regulation to a considerable extent, it could be argued that the creation of a single financial services regulator would be a logical next step. However, there are good reasons for resisting this conclusion.

First of all, one of twin peaks’ chief virtues is that it institutionalises the distinction between the systemic protection and consumer protection objectives, and between measures intended for the interprofessional markets and the retail consumer — thereby minimising the danger that specific regulations will be extended beyond the sphere for which they are appropriate. Since the needs of the interprofessional markets and the retail consumer are profoundly different, these objectives should be pursued by different bodies. Moreover, there are already profound differences between the style and techniques appropriate to prudential and conduct of business regulation, and these are likely to become more pronounced as prudential regulation moves further in the direction of the assessment of firms’ own internal risk control systems. It would be difficult to combine two such different cultures within a single organisation.

Secondly, as has already been remarked, it is inevitable that the twin objectives of public policy will come into conflict in certain cases; the Financial Commission model would institutionalise these conflicts within a single institution. This is undesirable because the resolution of conflicting objectives inevitably involves judgments about important issues of public policy, and it is therefore essential that the most important decisions should be taken at a political level. One of the benefits of the “twin peaks” model is that, by institutionalising the division between the systemic and consumer protection objectives, it ensures that all significant conflicts between them can only be resolved by a political decision. HM Treasury, both official and ministerial, will therefore continue to have an important role to perform in providing a bridge between the two peaks.

Thirdly, a single Financial Commission, with a remit covering both prudential and conduct of business regulation in banking, securities, and insurance and with the power to undertake civil proceedings against those it suspected of insider dealing or market abuse, could potentially become an overmighty bully, a bureaucratic leviathan divorced from the industry it regulates. The virtue of the “twin peaks” model is that, although it rationalises the existing system of regulation to a substantial degree, it stops short of creating such an immense concentration of power.

The international dimension

In the wake of the Barings episode, the problem of international regulatory fragmentation has moved higher up the policy agenda. Measures will need to be put in place to improve the information flows between different national regulatory authorities, and to improve co-ordination of regulatory action. Some developments have already occurred in this direction, but much more needs to be done.

It is beyond the scope of any one national authority to overcome these difficulties by its independent action. But national policy-makers should consider whether or not their present domestic regulatory arrangements do not materially contribute to the international problem of fragmentation. In recent evidence to the Treasury and Civil Service Select Committee, the former Chairman of the Securities and Futures Authority,
Christopher Sharples highlighted an international meeting at which the UK delegation had no fewer than eight representatives drawn from government departments and regulatory bodies. Seen from this perspective, the UK’s existing regulatory system appears unwieldy and inefficient. Under the “twin peaks” arrangement, by contrast, the FSC would be the only regulatory body which would need to take part in international negotiations on prudential standards. The prospect of international agreements on conduct of business issues is more remote, but the CPC would perform this role as and when it might be required.

The “twin peaks” model would also be consistent with existing European directives; indeed, as already noted, one of the reasons why a unified prudential regulator is now desirable is partly the result of one such directive, the Capital Adequacy Directive. On the other hand, Directives do not have a direct bearing on the regulatory structure which is charged with administering them, and while some – most notably the Investment Services Directive – make the division between wholesale and retail transactions more difficult to maintain, the difficulties they present would not be insurmountable.

Conclusion

It is possible to devise any number of regulatory systems which would display a greater degree of organisational coherence and tidiness than what has been called the present “cat’s cradle” of regulatory bodies. But achieving greater organisational tidiness alone would be insufficient to make the case for change. Moreover, it is doubtful whether a particular organisational structure can itself guarantee more effective regulation. The latter depends, crucially, on the quality of the individuals involved in regulation – and it must be emphasised that the case for “twin peaks” does not depend on a criticism of either the calibre or the commitment of those currently working in the regulatory agencies. But individuals are constrained by the institutional arrangements within which they must operate, and organisational change should be the product of reflection about the purposes and objectives of the system, and of how these might best be achieved.

The benefits of “twin peaks” are clear. The proposed structure would eliminate regulatory duplication and overlap; it would create regulatory bodies with a clear and precise remit; it would establish mechanisms for resolving conflicts between the objectives of financial services regulation; and it would encourage a regulatory process which is open, transparent, and publically accountable. As such, it is consistent with the current philosophy of “unbundling” the functions of public sector agencies, to achieve greater transparency, efficiency, and clearer lines of responsibility. In all these respects, it marks an advance over the existing institutional structure.

On the other hand, change involves costs, and there can be no denying that costs of change will be a concern for the industry. Savings will be achieved by the rationalisation of support services in the regulatory agencies, the simplification of regulation (especially in the wholesale markets), and the elimination of duplicate rulebooks. Notwithstanding these gains, however, significant investment has been made in compliance with the existing regulatory regime, and from the point of view of the firms this represents a substantial sunk cost.

Moreover, practitioners will be concerned about the potential running costs of the “twin peaks” system. Particularly contentious will be the funding of the two Commis-
sions and -- especially -- the funding of their compensation schemes. More work still needs to be done in these important areas, but the outstanding issues are primarily at the level of the detail of the proposals. This paper has been concerned instead with the principle of the "twin peaks" model.

It has become normal for discussion of the structure and effectiveness of the UK's regulatory system to take place against the background of specific events or perceived regulatory failures, thus contributing further to the fragmented and piecemeal nature of the system. In contrast to this reactive approach, the present paper has sought to base a redesign of the regulatory system on reflection about the aims and purposes of financial services regulation, and of how these might be best achieved in today's changed and changing financial marketplace. Because of its forward-looking approach, "twin peaks" might properly be described as a regulatory system for the new century.
Michael Taylor is principal lecturer and director of the masters programme in financial services regulation at London Guildhall University. He previously spent five years at the Bank of England, where he worked on banking supervisory policy and on issues relating to the Financial Services Act. He served as a member of the Fisher Group, a BIS working party which last year published a discussion document on the Public Disclosure of Market and Credit Risks by Financial Intermediaries.

Dr. Taylor was educated at Oxford University — where he also taught for three years before joining the Bank — and at Princeton.
FINANCING THE RUSSIAN SAFETY NET
by Peter Ackerman and Edward Balls
A proposal to fund employment benefit in Russia through the sale of bonds to Western investors. £40

DERIVATIVES FOR THE RETAIL CLIENT
by Andrew Dobson
How derivative instruments might be adapted for use by the retail customer to reduce risk. £20.

RATING ENVIRONMENTAL RISK
by David Lascelles
A scheme to rate companies according to their ability to handle their environmental liabilities. £25.

ELECTRONIC SHARE DEALING FOR THE PRIVATE INVESTOR
by Paul Laird
Using electronic media to supply stockbroking services directly to small investors. £25.

THE IBM DOLLAR
by Edward de Bono
How large corporations can issue their own currency. £15.

UK FINANCIAL SUPERVISION: A BLUEPRINT FOR CHANGE
by Andrew Hilton
A controversial proposal for amalgamating and rationalizing supervision of financial services. £25

BANKING BANANA SKINS
Five leading commentators examine the risk facing banks in the current economic cycle. £25

A NEW APPROACH TO CAPITAL ADEQUACY FOR BANKS
by Charles Taylor
A new and radical approach to setting capital levels, by the rapporteur of the recent G-30 report on derivatives. £35

THE EURO-ARAB DILEMMA: HARNESSING PUBLIC AND PRIVATE CAPITAL TO GENERATE JOBS AND GROWTH IN THE ARAB WORLD
by Jacques Roger-Machart.
Creating a Euro-Arab investment company to stimulate European investment in the Arab world. £25

BANKING BANANA SKINS II
Four leading UK bankers and a senior corporate treasurer discuss lessons for the future from the last banking crisis. £25

IBM/CSFIPRIZE: TECHNOLOGY AND FINANCIAL SERVICES 1994. PRIZE-WINNING ESSAYS
Two prize-winning essays. £10

LIQUIDITY RATINGS FOR BONDS
by Ian Mackintosh
A proposal to rate bond issues for liquidity. £25

BANKS AS PROVIDERS OF INFORMATION SECURITY SERVICES
by Nick Collin
Banks have a privileged position as transmitters of secure data: they should make a business of it. £25

AN ENVIRONMENTAL RISK RATING FOR SCOTTISH NUCLEAR
An experimental rating of a nuclear utility. £25

ECONOMIC AND MONETARY UNION STAGE III: THE ISSUES FOR BANKS
by Malcolm Levitt
Banks may be underestimating the impact of Maastricht's small print. £25

BRINGING MARKET-DRIVEN REGULATION TO EUROPEAN BANKING: A PROPOSAL FOR 100 PER CENT CROSS-GUARANTEES
by Bert Ely
A proposal for eliminating systematic banking risk by using cross-guarantees. £25

THE CITY UNDER THREAT
by Patrick de Laquetolle
A leading French journalist worries about complacency in the City of London. £20

THE UK BUILDING SOCIETIES: DO THEY HAVE A FUTURE?
A collection of essays by leading commentators (sponsored by the Alliance & Leicester). £20

OPTIONS AND CURRENCY INTERVENTION
by Charles R Taylor
A proposal for using an option program to defend exchange rate targets. £25
The CSFI wishes to thank the following for their generous support, without which the establishment and operation of the Centre would not have been possible:

Abbey National
Andersen Consulting
Barclays Group
Citibank
International Securities Market Association
Linklaters & Paines
London Stock Exchange
Merrill Lynch
Price Waterhouse
Private Bank & Trust Co
Stoy Hayward

Alliance & Leicester
Bank of America
Bank of England
Brown Brothers Harriman
Capital Markets Department, IFC
Davis International Banking Consultants
Department of Trade & Industry - Innovation Unit
Extel Financial
Gerrard & National/Lombard Street Research
HM Treasury
HSBC Holdings
IBCA
ICL
Industrial Investment Trust (Bombay)
Korn Ferry
KPMG Management Consulting
Lloyd's of London
Morgan Grenfell
Morgan Stanley International
National Westminster Bank
New England Investment Companies
Rockport Financial
Smith New Court
Standard & Poor's Ratings Group
Sun Life Assurance
Svenska Handelsbanken
Thom-EMI
Tokai Bank Europe
TSB Group

Anthony Cardew & Co
British Invisibles
Guildhall
Halifax Building Society
IBM (UK)
Peters Management Consultancy
Schroders

UK £25
US $40
CSFI ©