The Open University

The Future For Finance
The Financial Services Industry: Reform and Reinforcement of Regulation

Hello I'm Martin Upton from the Open University Business School.

In this podcast I'm providing an update on key developments and changes to the regulation of financial services in the UK in the second half of 2010.

Much has been going on in recent months, as politicians and regulators continue to reshape regulation in order to correct the failings highlighted during the recent financial crisis. A further impetus to these reforms has been the introduction of the new Coalition Government's policy agenda for the financial services industry following the general election in May 2010.

First, let's look at the plans for the reorganisation of financial services regulation announced by the Coalition Government.

By the end of 2012 the FSA will be wound-up and its responsibilities passed to three new agencies.

A new subsidiary of the Bank of England - likely to be called the Prudential Regulation Authority - will have responsibility for the regulation of banks and other deposit taking institutions, investment banks and insurers.

A consumer body - currently with a working title of the Consumer Protection and Markets Agency - will have responsibility for consumer protection in financial services, the regulation of conduct of business and market conduct. The FSA's responsibilities in respect of fighting financial crime will pass to an Economic Crime Agency that may well absorb the operations of the Office of Fair Trading (OFT) and the Serious Fraud Office (SFO).

The question currently is whether this re-organisation of regulation of financial services will simply be a case of changing reporting lines and responsibilities, or whether it will herald material changes to the way that regulation is undertaken.

The FSA's Chief Executive, Hector Sants, who is due to become the head of this new supervisory subsidiary of the Bank of England, seems to think the former, stating that he expects '...all (the recent) new policy decisions to be taken forward into the new (regulatory) structure'.

Next let's look at what's being planned in respect of the capital requirements for financial firms.

Capital is the money financial firms hold to cover for losses made in the course of their business – this happens, for example, when a borrower fails to repay a loan.

The financial crisis revealed that many financial institutions had insufficient capital to cover their potential and actual losses, forcing several, like Lloyds Banking Group and the Royal Bank of Scotland, to raise more capital though the issuance of more shares and debt capital.

In response to this problem regulators are moving to tighten up the capital requirements for banks and other financial firms with a package of measures collectively known as Basel III. These reforms to capital requirements will take effect in 2015 with the key initiative being that certain categories of debt capital may no longer be counted within a firm's Tier 1 capital ratio. Tier 1 capital is the core capital of a financial firm – effectively the last line of financial defence if a firm incurs losses. The consequence of Basel III is that in order to comply with the new minimum ratio, banks and other financial firms will need to raise substantial new capital that complies with the new rules. They'll need to do this in order to meet the minimum capital requirement of a Tier 1 ratio of 7 per cent of risk-weighted assets as required by Basel III.

Even before these new rules for capital requirements start to apply, the FSA is requiring financial firms to hold additional 'buffers' of capital that can be drawn on in times of financial stress. These additional requirements are set out by the FSA in its 2010 Policy Statement, 'Capital planning buffers'. This requires financial firms to carry out a 'firm-wide stress test' to assess how well they could cope in adverse financial conditions. These tests can then inform of the extent of the need for firms to hold additional capital.

We know that many attribute the recent financial crisis - at least in part - to the bonus culture in financial firms. Such a culture arguably encourages excessive risk-taking in the search of profits that can then be used to justify high bonus pay-outs.

In July 2010 the FSA announced plans to update its remuneration code to accommodate the remuneration rules required by the European Union's Capital Requirements Directive (CRD3) and the Financial Services Act 2010. The proposed plans are scheduled to take effect from 2011.The proposals build on the requirements of the existing remuneration code which stated that firms should have remuneration policies consistent with the promotion of effective risk management. Amongst the proposals is a requirement for at least 40 per cent of bonuses to be deferred over a period of at least three years, rising to 60 per cent for bonuses above £500,000. In addition, at least 50 per cent of performance-linked remuneration must be in shares or in other non-cash forms. In respect of guaranteed bonuses these may not be for periods of more than one year and may only be given in exceptional circumstances to those newly hired by firms.

The FSA requires that financial firms comply with the regulatory rules governing the management of client assets – the key principle is that client assets should at all times be segregated from the assets of the financial firm that is managing them.

In 2010 the FSA re-enforced the requirements of the Client Assets Sourcebook, known as CASS, through its Policy Statement the Client Assets Sourcebook (Enhancements) Instrument. The measures were in response to issues relating to client assets that surfaced during the financial crisis - particularly those identified following the insolvency of Lehman Brothers. Amongst the measures are greater restrictions on the investment of client money with institutions within the same banking group as that holding the client's account. This is designed to diversify the investment of clients' money thereby avoiding excessive credit exposure to one or a few financial firms. There's also a requirement for financial firms to establish a CASS controlling function.

Financial firms have to deal with FSA rules when it comes to dealing with complaints by customers. These rules are in the process of being reinforced.

In September 2010 the FSA published a Consultation Paper proposing changes to the handling of complaints by financial firms. The proposals include the abolition of the two-stage process for handling complaints to encourage firms to resolve complaints effectively first-time around. Other proposals include the requirement for firms to have a senior individual responsible for the handling of complaints and for them to carry out 'root cause' analysis by locating and remedying recurrent and systemic issues giving rise to complaints.

A further proposal is to raise the maximum award that may be made by the Financial Ombudsman Service from £100,000 to £150,000. A Policy Statement on these issues is expected in 2011 following the outcome from the consultation period.

The recent financial crisis and the demise of certain banks highlighted the protection afforded to customers under the Financial Services Compensation Scheme. From the end of 2010 the maximum protected sum for deposits under the scheme is to be raised from £50,000 per person per financial firm to Sterling equivalent of €100,000. This will align the UK protection level with the maximum protection of €100,000 in respect of depositors in the Euro zone.

Please also note that the maximum compensation for protected investments is now £50,000. This replaces the pre-2010 limit of 100% of the first £30,000 plus 90% of the next £20,000 (overall a maximum of £48,000).

A further feature of regulation in 2010 has been the intensity with which the FSA is applying its policing and enforcement duties.

Several prosecutions have taken place in respect of insider dealing – a form of market abuse. The consequences for those found guilty of insider dealing are severe with heavy fines and custodial sentences being imposed. Additionally there have also been substantial confiscation orders. In one case a convicted insider dealer was ordered to pay confiscation amounting to £500,000 despite the fact that the profits from the illegal transactions were only around £100,000.

We've also seen action taken for the first time by the FSA under the Money Laundering Regulations of 2007. This came when the Royal Bank of Scotland was fined £5.6 million in 2010 for failing to ensure it complied with sanctions and asset freezes imposed by the UK government. Although violations of asset freezes and money laundering are different the practical measures to prevent them are broadly the same. Consequently the FSA used the Money Laundering Regulations to pursue the failings of the Royal Bank of Scotland.

Enforcement is set to get tougher - particularly now the Financial Services Act 2010 has come into force. Amongst the Act's provisions are greater penalties for those who fail to comply with financial services regulation. The FSA may now both impose financial penalties on firms found guilty of regulatory offences and withdraw a firm's authorisation. Previously the FSA could not do both simultaneously. The 2010 Act also extends the FSA's powers to suspend, limit or otherwise restrict the permissions granted to authorised firms to conduct regulated activities.

Financial services regulation is currently experiencing major changes - both in terms of its organisation and in terms of the more stringent requirements, for example in respect of capital, that are being placed on financial firms. The legacy of the financial crisis looks set to place a greater onus on firms to manage their risks effectively, deal fairly with customers and operate remuneration policies that attract and retain quality employees whilst not alienating the government and the public.