

# Labour's Record on Financial Regulation<sup>1</sup>

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In 1997 the New Labour government launched major initiatives in the area of financial regulation, consolidating regulation under a new Financial Services Authority and enacting new legislation that was proclaimed to be 'light-touch' and yet comprehensive. The new regime, widely admired in its initial years, came to be severely tested by the events of global financial crisis that started in 2007. We evaluate the Labour government's on financial regulation in terms of its achievements and failures, but also assess, more generally, the limits of financial regulation.

*Keywords:* financial regulation; New Labour, financial crisis.

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## I. INTRODUCTION

The formation of the New Labour government in 1997 was marked by seemingly bold initiatives in the area of financial regulation. Even as it handed over operational independence for monetary policy to the Bank of England, it announced the transfer of banking supervision to a new body, to be called the Financial Services Authority (FSA). Apart from assuming responsibility for the prudential regulation of banks, this new authority was to serve as a statutory regulator for the financial sector, replacing the existing patchwork of multiple sector-specific licensing and self-regulatory bodies. This institutional re-design of financial regulation was matched by a new legislative framework, which eventually came in the form the Financial Services and Markets Act, 2000. Despite the desire to have comprehensive regulatory coverage across various financial services, from banking and investment services to insurance, the proclaimed intention was to create a regime of 'light-touch' regulation, that would support the City of London's pre-eminence as a financial centre.

For much of the first two terms of the Labour government, the new regulatory structure seemed successful. The macroeconomic environment was favourable with steady growth and price stability. The City came to be regarded as a hub for financial innovation, and with financial services making a sizeable contribution to the UK economy. There were signs of a growing mis-alignment of asset prices – especially a house-price boom fuelled in part by easier access to mortgage lending – but there were relatively few immediate financial failures or scandals.

The edifice was tested by the events of the global financial crisis that emerged during Labour's third term (2005-10). In the wake of losses on sub-prime mortgage loans a sudden constriction of liquidity in global financial markets put a strain on many UK financial institutions. Northern Rock, which had relied quite heavily on short-term wholesale borrowing to expand its mortgage loan book, ran into liquidity problems. While Northern Rock did secure liquidity support from the Bank of England, delays and confusion in the regulatory response triggered what came to be regarded as the first bank run in the UK in over 150 years. A series of other impending failures led to direct (and much more expensive) interventions in the form of recapitalization of the Lloyds and Royal Bank of Scotland groups.

These events led, inevitably, to a re-assessment of the regulatory structure created by the Labour government, and a call for re-design of the institutional arrangements. Most notably, the Financial Services Authority is to be replaced in 2013 by two separate bodies: the Prudential Regulatory Authority will return banking supervision to the Bank of England; while a distinct Financial Conduct Authority will remain as an independent body.

This paper assesses New Labour's record on financial regulation. We begin in Section II by setting out the theoretical rationale for financial regulation. Financial markets display many of the classic market failures – information asymmetries, externalities, etc. – that make a potential case for regulatory intervention. The regulatory imperative is even stronger where the failure of individual institutions can have very large effects on individuals, and systemic financial crises can have large effects on the real economy. We explore specific forms of financial regulation (ranging from who is allowed to trade in financial services, and public disclosure requirements, to capital adequacy requirements to minimise the risk of failure), and their suitability.

Section III presents a brief history of financial regulation in the UK prior to 1997. Unlike the US which evolved an extensive system of statutory regulation in the aftermath of the Great Depression, the City of London evolved with a largely self-regulatory system that controlled participation in financial markets (eg., who could accept deposits) and the conduct of those who were allowed to participate. With the nationalisation of the Bank of England in 1946, it did acquire some regulatory oversight but it exercised this in relatively informal ways. Other sectors of the financial services industry (building societies, insurance companies and intermediaries in the broader securities industries) evolved forms of self-regulation. Formal regulation structures did emerge gradually in the second half of the 20<sup>th</sup> century, mostly in reaction to particular financial failures and scandals, but the evolution was piece-meal.

Section IV provides details of the regulatory reforms carried out by the Labour government, notably the creation of the FSA and the enactment of the Financial Services and Markets Act 2000. Section V reviews the response of the government to the financial crisis, focussing on two specific events – the run on Northern Rock in 2007 and the recapitalisation of the Royal Bank of Scotland group in 2008 – to identify weaknesses in the regulatory structure.

Section VI offers an evaluation of the regulatory structure at two levels. Labour's regulatory design was clearly a product of its times, drawing from then prevalent 'conventional wisdom' of the ability of markets to regulate themselves. We assess the extent to which the regulatory design fell short relative to what would have been reasonable even given what the conventional wisdom was. At a different level, we marshal the advantages of hindsight, and ask to what extent Labour's creation fell short of what we might now consider a well-designed regulatory regime. This assessment is carried out in the din of an ongoing debate about the method, extent, and even feasibility of financial regulation. If even after five years of analysing events since 2007, there is as yet no clear consensus on financial regulation, we cannot be too harsh in judging Labour's record. Section VII concludes.

## II. THE RATIONALE FOR FINANCIAL REGULATION

The financial system plays an important role in transferring resources from savers to the investors, so its efficient operation is crucial for proper resource allocation in the economy. Direct financing—small agents directly buying stocks and bonds—accounts for only a small part of the flow, mostly because this channel is beset with market failures arising from information asymmetries. Indeed, intermediaries such as deposit-taking banks emerged as a solution to these problems through their ability to screen and monitor borrowers. But the behaviour of financial intermediaries is itself vulnerable to moral hazard and adverse selection.

Financial regulation consists of efforts to protect individuals in their financial transactions and to reduce the risk of crises within the financial system as a whole. Individual customers are not always able to monitor or audit the conduct of firms they deal with, because they may lack the resources for costly monitoring, and given that any acquired information has a ‘public-good’ aspect, they may prefer to free-ride on others. It follows that leaving information collection to individuals results in too little monitoring or auditing relative to the social optimum, leaving individual consumers vulnerable to misconduct by firms. The possibility of misconduct would lead to lower demand and unexploited gains from trade, giving rise to a scope for efficiency-enhancing regulation of business conduct. In most modern economies there are licensing restrictions on who can act as a financial intermediary and on the operational behaviour of those who are so licensed. The intention is to protect individual customers of financial intermediaries from fraud and other forms of market abuse such as insider dealing.

Moreover, where the self-interested decisions of individual financial intermediaries entail the risk of their failure, there is a case regulating their choices to reduce that risk. If the investment decisions of highly-leveraged<sup>2</sup> firms with are made primarily in the interest of equity holders with limited liability, they have a distorted incentive to choose too risky a portfolio, relative to that which is optimal for all claimholders. Once again there is potential for efficiency-enhancing regulation that reduces risk exposure of informationally-small agents such as deposit holders.<sup>3</sup> ‘Microprudential regulation,’ which mandates minimum capital requirements and carries out periodic monitoring and supervision to limit risk-taking, can make such firms safer and protect its claimholders.

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<sup>2</sup> Leverage is defined as the ratio of the value of assets (A) to equity (E) (which is also called capital). Since value of assets equal liabilities, and the latter consists of debt (D) and equity,  $\text{leverage} = A/E = 1 + D/E$ . A firm that borrows some funds would have a leverage ratio in excess of 1. As a firm borrows more funds keeping equity unchanged, its leverage increases.

<sup>3</sup> The argument that informationally-small agents require protection has been developed in the context of prudential regulation by Dewatripont and Tirole (1994). As Campbell et al. (2011) point out, consumers may also be disadvantaged by cognitive limitations and the limited scope for learning through experience in transactions that are carried out only occasionally (e.g. acquiring a mortgage) and whose outcome is known with a long lag.

A second aspect of financial intermediation is maturity transformation. Banks, for instance, finance long-term investments using short-term liabilities such as demand deposits. Since banks only hold a small part of their total deposits in liquid form, a sudden surge of withdrawals can lead to a bank failure. This feature leaves a bank vulnerable to a bank run in the event of confidence problems: if other depositors withdraw funds, the rational response of any individual depositor is to withdraw funds too. In such settings, depositor protection can play a valuable role in maintaining depositor confidence. With adequate and credible depositor protection, an individual depositor has no particular incentive to withdraw funds only because other depositors are doing so. Depositor protection rules out the 'run' equilibrium, and maintains confidence in the financial system.<sup>4</sup>

If deposits are so protected the argument above about regulation as a form of customer protection has no force. However, information asymmetries make fair pricing of deposit protection difficult, leading again to distorted risk-taking incentives which potentially impose a negative externality on the deposit protection fund, which itself may be implicitly guaranteed by the public exchequer. Thus, in this case, reducing the probability of bank default by imposing a microprudential capital standard is a measure to protect the fund as well as depositors. There are also other types of public insurance that justify regulation. For example, there is the so-called 'too-big-to-fail' problem: some large banks attain such an important status that they would invariably be rescued by the government if in trouble. Since, again, the public exchequer is at risk from such implicit guarantees, there is an economic case for applying microprudential regulation to such institutions.

However, safety of individual banks or other financial intermediaries per se need not ensure systemic safety. As we discuss below, actions by individual financial intermediaries following a loss can impose a negative externality on the intermediation system as a whole. It can be argued that such 'macroprudential' concerns call for further regulation to internalize the systemic externality.<sup>5</sup> Further, a systemic failure implies that explicit (deposit protection) and implicit (bailing out 'too-big-to-fail' institutions) guarantees must actually be honoured, leading to large debt burdens.

In the conventional view, the idea of systemic risk was explained using mainly the 'domino' model, which posits that failure of a bank leads to losses at other banks through chains of interconnections among banks. If bank A owes funds to B, and B in turn to C, then a default by A affects B negatively, which in turn has a

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<sup>4</sup> Note that deposit protection offered to customers of a fully-solvent bank is, in theory, costless: it maintains confidence, but no payment is ever needed from the depositor protection fund. In a systemic failure, however, this can be costly, as we discuss later.

<sup>5</sup> Conventional banks do however have a special role as a repository of exclusive information on borrowers. A systemic failure implies a loss of such information and may lead to a credit crunch, with adverse consequences for output. Bernanke (1983) shows the importance of the loss of information-generating banks in propagating the Great Depression.

negative impact on C, and so on. However, as Brunnermeier et al. (2009) note, under plausible parameter values, simulations of calibrated versions of the domino model show that the impact of the domino effect on the system tends to be small. Indeed, viewing systemic risk purely as a domino phenomenon may have led regulators to underestimate the problem.

The recent financial crisis has highlighted the role of other factors that can endogenously amplify a small initial shock into a system-wide failure. Suppose an intermediary needs to maintain a certain minimum ratio of its equity capital to its assets. This could be because as a regulated bank it is subject to minimum capital regulation, or even as an unregulated financial intermediary it needs to maintain a minimum capital ratio to maintain confidence of its debtors. An intermediary who experiences a loss can restore its capital ratio falls either by raise new capital or by selling some assets reduce its debt. Raising new loss-bearing capital can be very difficult in a downturn, especially when the firm has already made losses.<sup>6</sup> The intermediary is likely to reduce the size of its balance sheet by selling some assets. If a single intermediary behaves in this manner, it can quite possibly sell some assets at their current market price, and re-balance its books. However, if many intermediaries are in similar trouble, and all try to sell assets, this depresses the price of the asset. Since assets are valued at market prices ('marked-to-market'), this, in turn, further worsens leverage, requiring further sales which further lower prices and so on. Repeated rounds of such 'fire-sale' endogenously amplify the initial problem. As Shleifer and Vishney (2011) note, firms impose on each other a fire-sale externality.<sup>7</sup>

Further, balance-sheet-shrinkage also means banks make fewer new loans, giving rise to a credit crunch. Indeed, a substantial body of evidence shows that banks reduce lending in response to higher capital requirements.<sup>8</sup> It follows that microprudential safety measures by themselves do not promote either systemic

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<sup>6</sup> New investors, the most junior claimants, expect to be the first to bear any further losses. This 'debt overhang' problem implies that investors are likely to be reluctant to contribute new capital. Attempts to raise new capital can also act as a signal of financial distress, making capital-raising difficult. While such a signalling problem can be overcome if the regulator requires banks to raise new capital, the debt-overhang problem persists even in this case.

<sup>7</sup> During the recent crisis, with the emergence of problems in the mortgage-backed securities market and related markets (e.g. the market for credit default swaps), a "run" started in the repo markets (Gorton, 2010, Gorton and Metrick, 2010). This led borrowing banks to liquidate assets at fire-sale prices, exacerbating their losses. A further problem of "margin spiral" (Brunnermeier and Pederson, 2009) occurs if the permissible leverage ratio itself changes in response to the losses. In particular, short term lenders in financial markets can demand higher margins or haircuts in response to initial losses. The fact that the borrower now has to put up even more "capital" than before exacerbates the problem further and leads to further sales of assets and consequent systemic problems. Indeed, in the recent crisis, with the run on repos, lenders also started demanding higher haircuts. See Adrian and Shin (2010) for evidence of a margin spiral.

<sup>8</sup> See, for examples, Hancock and Wilcox (1993, 1998), Peek and Rosengren (1997), Ito and Sasaki (1998). Using UK data, Francis and Osborne (2009) find that a single percentage point increase in 2002 would have reduced lending by 1.2% and total risk weighted assets by 2.4% after four years.

stability or optimal credit provision. ‘Macroprudential regulation’ attempts to get to grips with this problem through some form of contingent capital requirement, time-varying capital regulation scheme, or other schemes.<sup>9</sup>

While macroprudential regulation attempts to address systemic instability within the regulated sector, there is a further source of systemic instability that arises as a result of regulation, one that can undermine the effectiveness of macroprudential regulation: the so-called ‘boundary problem’. Regulations impose costs on regulated parties, creating incentives to circumvent those regulations by relocating their activities outside the regulatory boundary.<sup>10</sup> With the emergence of a ‘shadow-banking sector’, there exist a variety of investors (hedge funds, structured investment vehicles (SIVs) set up by banks, broker-dealer funds, etc.) who buy asset-backed securities and fund these purchases with short-term credit. While the financing model for these entities is similar to that of a deposit-taking bank, as these activities lie outside the purview of regulation, their cost of funds may be lower – at least in good times. If the market for short-term funds become illiquid, we can again get a bad ‘run’ equilibrium in which lenders refuse to rollover part (or all) of the short-term loan.<sup>11</sup> In other words, the financing model is subject to a confidence problem, and is open to the possibility of a rapid reduction in lending.

While the sector was much impaired in the recent crisis, it continues to have a significant presence. Based on US data, Pozsar et al. (2010) report that in March 2008, the shadow banking sector had reached the size of \$20 trillion, falling to \$16 trillion at the start of 2010, which is still larger than the size of the banking sector (around \$13 trillion). The large size of this sector, its complex web of transactions that are often intertwined with those of the banking sector, and its fragility, all make it a systemically-important sector. If so, systemic safety may remain elusive for as long as the remit of regulation is restricted to the formal banking sector. Hanson, et al. (2011) argue that, in consequence, similar capital standards should be imposed on any given type of credit exposure, irrespective of who holds the exposure.

While standard consumer protection arguments imply that all firms should be subject to conduct regulation, how do we decide the degree to which a firm is systemic? Brunnermeier et al. (2009) propose the following classification of financial firms according to their systemic footprint. First, some large institutions

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<sup>9</sup> See Kashyap et al. (2011) for a discussion of several types of macroprudential policies. See also the Squam Lake Report (2010).

<sup>10</sup> See Brunnermeier et al. (2009) for a discussion of the boundary problem.

<sup>11</sup> For example, in a repo transaction, the lender receives, say, an asset-backed security worth 100 in return for a loan. Factoring in the possibility that the value of the asset might decline, the lender might want to lend, say 95 against the asset, leaving the borrower to fund the rest. This 5% is known as the ‘haircut’ imposed by the lender. Lenders can withdraw funds by increasing the haircut on a loan, and in the extreme case they might refuse to rollover loans at all, implying a haircut of 100%. See Gorton (2010), Gorton and Metrick (2010) for a detailed discussion of the run in the repo market in the run-up to the recent crisis. See also Covitz, et al. (2009) for a discussion of the sudden collapse in the asset-backed commercial paper market during the recent crisis.

may be individually systemic, in that their failure would damage the entire intermediation system. Second, some classes of firms such as highly-leveraged hedge funds are not individually systemic, but if they choose similar strategies and therefore have positively-correlated returns, they can be systemic as a group. Firms that are systemic in this sense require macroprudential regulation in addition to any microprudential regulation.

These arguments imply that simply imposing high capital standards on banks in isolation may not work. Even if the right macroprudential corrections are made to capital requirements, they may not have the intended effect (and may even have perverse effects) while the shadow banking sector remains unregulated. At the same time such regulation is unlikely to be without costs – both financial and political (an issue we discuss further below in our evaluation of the events of the recent crisis).<sup>12</sup>

Raising capital requirements significantly may have long-run costs, although estimates vary widely. Based on calibrating a model using the Modigliani-Miller approach, Kashyap, et al. (2011) suggest that raising capital requirements by 10% would increase lending rates by 25 to 45 basis points and also increase the incentive of banks to move financial activity into the unregulated shadow sector.<sup>13</sup> Further, as they point out, this queries the appropriateness of raising capital requirements in an upturn, which is a central macroprudential prescription for enhancing systemic safety. In an upturn, shadow banks may face the smallest spreads on their borrowing rates. If this is the case, raising the cost of bank funds in an upturn by requiring them to hold a higher level of costly capital would make shadow banks seek more non-bank liquidity from sources such as the repo market and auction-rate securities. Since these markets are vulnerable to a rapid withdrawal of funds,<sup>14</sup> such a migration away from the banking sector to short-term funding from unregulated sources may increase systemic vulnerability.

All of this is to say that achieving systemic stability is difficult, and only after a crisis can there be some political will to implement tougher measures. It may be

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<sup>12</sup> For example, Francis and Osborne (2009) simulate the impact of a countercyclical capital requirement in the UK imposing three one-point rises in capital requirements in 1997, 2001 and 2003. They conclude that by the end of 2007, these might have reduced the stock of lending in the UK by 5.2% and total risk-weighted assets by 10.2%. While it might be argued that this reduction, in reducing the extent of the lending boom, might also have reduced the pain of the subsequent adjustment; it is easy to guess that, at the time, such measures would have been very unpopular.

<sup>13</sup> For example, banks can reduce capital requirements by not holding the loans at all (i.e. not even in off-balance-sheet SIVs that have recourse to the bank balance sheet if distressed). Kashyap et al give the example of a pool of loans being acquired by a hedge fund, which finances the purchase using the repo market. This transaction avoids capital regulation (assuming that only banks are regulated), and increases systemic fragility.

<sup>14</sup> See, for example, Han and Li (2010) for a description of the fragility of the auction-rate securities market.



unrealistic to expect that a government would raise the regulatory burden significantly when the economy was enjoying a prolonged upswing.

We should note two important caveats that tend to be neglected in the literature on financial regulation. First, this conventional picture of banking represents only a fraction of the activities of many large modern banks, which by the time Labour came to power were earning large parts of their revenue from other activities, most notably investment banking and derivatives trading. Second, (conventional) banking is not the *only* solution to the problem of information asymmetries faced by the small investor. A very large (in the UK, the dominant) component of intermediation is carried out by pension funds and unit trusts, which have a very different business model from banks. In particular, while the conventional bank has relatively illiquid assets compared to its liabilities, a pension fund is typically in the opposite situation with long-term pension liabilities matched by portfolios of typically highly liquid (if also typically long-dated) securities. It is striking how little attention this form of intermediation receives compared to conventional banking.

### **III. FINANCIAL REGULATION IN THE UK BEFORE 1997**

Unlike the United States, where the structure of financial regulation was established in the aftermath of the Great Depression, regulation in the UK evolved more organically. During much of the twentieth century, a relatively cartelised financial industry in the UK developed a pattern of self-regulation. As Goodhart (2000) points out, the financial sector developed in the form of largely self-regulating, ‘cartelised clubs of semi-specialised intermediaries’. To the extent this oligopolistic structure avoided major financial failures, it mitigated the need for external supervision. The Bank of England Act 1946, which nationalised the Bank of England, gave it only the powers to “request information from and make recommendations to bankers”; it had some powers to issue directions to bankers, but as Robb (1997) notes, no such directions were ever issued under those powers.

The evolution of regulation in the second half of the century was largely reactive with major regulatory initiatives typically following episodes of financial failure or scandal. The risk of financial failure grew naturally as the relatively stable economic growth of the early post-War decades led to the emergence of a fringe financial sector that was able to attract wholesale deposits, often of short maturities, creating some risk of mismatch between maturities of assets and liabilities. With increased international competition and financial innovation that blurred the distinctions between different lines of financial activity gradually put strain on the profitability of banks, increasing the risk of failures. This, by itself, made a case for more formal regulation and supervision of banks and other financial firms. Moreover, following UK’s entry into the EEC in 1973, and the growing presence of foreign banks’ subsidiaries and branches in London, there was a perceived need to harmonise bank regulation with that in other countries. In 1974 the Bank of England invited the larger banks to submit to voluntary supervision.

However, it was only in 1979, with the first UK Banking Act, that the Bank of England acquired any legal powers and sanctions over banks, and created the statutory requirement that deposit-taking activity be restricted to authorised or licensed institutions. The Banking Act of 1987 further enhanced the Bank's supervisory powers, especially its power 'to investigate and seek information' and also reinforced the deposit protection scheme that had evolved in 1982.

Even these enhanced supervisory powers were tested by the collapse of Bank of Credit and Commerce International (BCCI) in 1991. The official report on the collapse concluded that 'banking groups which deny supervisors a clear view of how business is conducted should be outlawed', recommending that Bank of England should deny or revoke authorisations of banks if their supervision was impossible. In response, the Bank set up a Special Investigations Unit to guard against fraud.

In 1995 Barings Bank ran into trouble due to overseas trading losses of its subsidiary, Barings Securities. In response, the Bank of England's Board of Banking Supervision called for tighter regulation of banking groups that were also engaged in non-banking lines of business, especially in relation to the inherent risk posed by those activities on the authorized bank.

When it comes to the regulation of non-bank financial services, their recent history can be described as one that involved structural de-regulation followed by increased regulation of their conduct. The so-called Big Bang reforms in 1986 involved a switch from the traditional open-cry to electronic trading on the London Stock Exchange, but it brought an end to fixed commissions on securities trades and broke down the traditional distinction between 'stockjobbers' and stock-brokers. The impact on the market structure was stark: it allowed investment and clearing banks, both domestics and foreign, to buy out the members of the stock exchange members to create financial conglomerates.

Historically financial services were very lightly supervised, with regulation restricted to legislation against fraud (eg. The Prevention of Fraud (Investments) Act). Licensing requirement, when they existed, were modest and allowed significant exemptions. For instance, individuals and firms that dealt in securities were notionally subject to licensing requirements, but members of the Stock Exchange, deemed to be financially sound, were exempt from this requirement. Insurance companies had long been only loosely regulated by the Life Assurance Companies Act 1870. The collapse of some insurance companies (Fire Auto and Marine in 1966, and Vehicle and General in 1971) prompted the Department of Trade and Industry (DTI) to institute a stronger system of prior authorisation and led to further bouts of legislation (Insurance Companies Act in 1974, the Policyholder Protection Act 1975, and later a new Insurance Companies Act in 1982). Following a review in 1974, the DTI also sought to tighten the licensing regime for those who could trade in securities.

Building societies had historically been mutually-owned bodies that offered mortgages funded by retail savings. Restrictions on their activities were progressively relaxed through legislation (notably the 1986 and 1996 Building

Societies Acts), allowing them to compete with banks in offering conventional payment and other banking services. These changes were also followed by a spate of 'de-mutualizations'. Even as there were a blurring of distinctions between the previously largely segmented markets of building societies and conventional banks (which in turn began to compete with building societies in the market for mortgages) the former remained under the supervision of a separate body, the Building Societies Commission.

The 1980s also saw reinforcement of investor protections. The Financial Services Act 1986 drew on the report of the Gower commission, which had been set up to review investor protection in securities and units trusts. The Act left day-to-day regulation of various activities with existing professional bodies and 'self-regulatory organisations' (the SROs) – these included, apart from various professional bodies, the Securities and Futures Authority (SFA) for securities; the Investment Management Regulatory Organisation (IMRO) for fund managers; the Personal Investment Authority (PIA) for financial advice. In a two-tier structure, a Securities and Investment Board was created for the oversight of these SROs: firms were required to seek membership of a self-regulatory organisation (SRO) or be directly regulated by the SIB.

To summarise, the structure of UK's financial structure as New Labour came to power in 1997 was quite fragmented. Banks were supervised by the Supervision and Surveillance Division of Bank of England under the Banking Act of 1987. Building Societies were supervised by the Building Societies Commission, itself a part of the Register of Friendly Societies. Insurance was regulated by a division of the Department of Trade and Industry, except Lloyds which was self-regulated. The securities sector was regulated under a two-tier system which involved self-regulatory organisations and professional bodies, under the overall supervision of the Securities and Investment Board. Some activities, such as trade in futures, were outside the purview of regulation, as they were not classified as securities under contemporary legislation.

There had long been an emerging case for the consolidation of this regulatory infrastructure. As early as 1981, the Wilson Committee had argued that, with the blurring of different activities of financial intermediaries, and the rise of financial conglomerates that straddled various lines, there was a case for consolidation of regulation under a single regulatory authority. This issue came to the fore almost immediately after New Labour came to power

#### **IV. REFORM OF FINANCIAL REGULATION UNDER NEW LABOUR**

Almost immediately on coming to power in 1997, the New Labour government announced operational independence for monetary policy to the Bank of England, a move later formalised under the Bank of England Act 1998. This was accompanied by significant redesign of the architecture of financial regulation in the UK. This was manifested in the creation of a unitary Financial Services Authority (FSA) and the later enactment of the enabling legislation, the Financial

Services and Markets Act 2000 (FSMA 2000). In this section we focus on three aspects of New Labour's regulatory reform. First, we outline the salient features of the institutional structure that was created. We then examine the specifics of the prudential regulation of banks in the new structure. Finally we discuss what we call the choice of 'regulatory intensity', notably the desire to create a regime of 'light-touch' regulation.

### **(a) The institutional design of financial regulation**

The Financial Services Authority was set up as a successor organisation to the existing Securities and Investment Board, and took over the supervisory function of eight other bodies. The most notable among these was the Supervision and Surveillance Division of the Bank of England but the list also included the previously self-regulated organisations mentioned earlier; the Building Societies Commission (BSC), the Friendly Societies Commission; the Registrar of Friendly Societies; and the Insurance Directorate of the DTI. Later, in 2004, the FSA also took over the regulation of mortgage lending and in 2005, the regulation of general insurance.

The role of the FSA was not fully set out until the passing of the Financial Services and Markets Act 2000. Under the Act, the FSA was given responsibility for the overall supervision of financial markets, for consumer protection, for reduction of financial crime, and to 'maintain confidence in the financial system'. This implied a long task list:

- to regulate deposit taking, safekeeping and administration of assets, dealing in and managing investments, and providing investment advice;
- to establish a single authorization regime for all regulated activities;
- to introduce new sanctions to restrain abuse of markets;
- to establish the Financial Service Compensation Scheme, unifying the previously separate schemes for banks, building societies, insurance companies, and securities and investment firms.

The government created a tripartite system for regulation of banks, made up of the FSA, the Bank of England, and HM Treasury. The FSA had the explicit responsibility for the micro-prudential regulation of banks, but it was unclear whether its objective of 'maintenance of confidence in the financial system' amounted to a macro-prudential function. The Bank of England Act 1998 gave the Bank an objective '*to contribute to* protecting and enhancing the financial stability of the UK' but it was not entirely clear how the Bank's financial stability objective articulated with the FSA's micro-prudential functions: notably there was no direct FSA representation on the Bank's Financial Stability Committee. The Treasury was made responsible for 'the overall institutional structure of financial regulation and the legislation which governs it'. There were various memoranda of understanding that agreed that in a systemic crisis, the FSA and the Bank were to decide jointly whether any action from the Treasury was called

for. As we discuss below, when the crisis did turn up this tripartite system was found wanting.

### **(b) Prudential regulation of banks**

The prudential regulation of banks has been built around the imposition of minimum capital requirements on individual banks. The first international standard for risk-based bank capital requirements was proposed in 1988 by the Basel Committee on Banking Supervision. The Basel rules are an attempt to achieve international convergence in capital standards, which were deemed a necessary condition for well-functioning credit markets with both domestic and foreign banks.<sup>15</sup>

The 1988 Basel Accord imposed minimum capital requirements of 8% of a bank's risk-weighted assets. Each asset was assigned to one of four risk buckets, with each bucket having a particular risk weight. After criticism for being too crude a measure of risk, and for considering only credit risk, the committee amended the rules in 1996 to cover market risk as well. In 1999, the rules were overhauled, and a new framework, commonly known as Basel II, was proposed. The new rules were organized into three pillars. The first pillar on capital regulation allowed for greater flexibility in measuring risk, often relying on banks' own risk management models. It also set capital charges against several types of risks (such as interest rate risk and operational risk) not previously covered by regulation. The second pillar stressed supervisory review of the capital position of banks, and the third pillar encouraged banks to disclose information. Presumably the last pillar was meant to promote market discipline, although it did not specify any operational concept of such discipline.

From the early 1990s, the UK regulatory regime used Basel I rules as the benchmark for its regulatory framework. The Basel standards have always been the internationally-agreed minimum standards, and not necessarily covering all types of risks (the amended Basel I covered only credit risk and market risk), requiring further local adjustments when implemented by individual countries. The supposedly improved Basel II framework was formally adopted in the UK in 2006.<sup>16</sup>

The UK regulatory regime was (and remains) somewhat unique in that the FSA has continued the Bank of England's practice of setting *bank-specific* 'trigger ratios', which are regulatory minimum capital ratios. These are usually set at levels *above* the minimum Basel requirements, and reviewed every 18 to 36 months. A breach of the trigger ratio is regarded as a serious regulatory violation, leading to severe regulatory intervention and potential loss of licence.

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<sup>15</sup> Basel Committee proposals are not legally binding, but the 27 member countries, and some others, are expected to enshrine the proposals in their national regulatory framework.

<sup>16</sup> In the aftermath of the recent crisis, a new set of rules (Basel III) have been proposed, partly adopted in the UK by 2012, and to be fully adopted in the future.

The Bank of England used to set a 'target ratio' above the trigger ratio, with the specification that any breach of the former would trigger regulatory attention on the bank. The FSA discontinued the use of the target ratio, adopting instead the more informal policy of encouraging banks to hold a capital buffer above the minimum trigger. The use of trigger ratios provides an interesting, and under-researched, testbed for the use of time-varying capital ratios sometimes proposed as a method of macroprudential regulation.

### **(c) Regulatory intensity**

One of the features of the New Labour's regulatory regime was its much-proclaimed emphasis on 'light-touch' regulation. This stated preference must be considered in its historical context. The 1990s were widely seen as an era of success of free-market capitalism, especially in the area of finance. This was only natural in a period of intense financial innovation and the rise of financial services as an important element in the continued growth in the Anglo-Saxon economies.

In this setting, the newly-elected Labour government had a particular desire to appear market-friendly. The Labour party was keen to shake off its poor track record on economic policy, based in the experiences of the Callaghan government in the late 1970s, a perception that had damaged the party in electoral terms all through the 1980s. Meanwhile, the long period of Tory government from 1979 to 1997 had changed the economic landscape, with Big Bang reforms in the City and the many privatisations of state-owned utilities. By the mid 1990s the Labour party was eager to adopt and proclaim new business-friendly credentials.

The mid-1990s were also a period of considerable anxiety about the City of London's status as a global financial centre. UK's undignified exit from the Exchange Rate Mechanism in 1992, and the subsequent reluctance to adopt the Euro had created the impression that London was at risk of being left outside the European mainstream. The established financial institutions in the City used their considerably lobbying power to make case for a softer regulation. The preference for light-touch regulation received intellectual legitimacy from the then-popular Greenspanian idea that the self-interest of financial institutions can serve as a sufficient regulatory force in free markets. In the US, with a more extensive financial regulatory structure, the passing of the Gramm-Leach-Bliley Act (1999) had broken down the Glass-Steagall separation of investment from commercial banking.

It is important to appreciate how this mindset shaped Labour's reform process. The previous major regulatory legislation, the Financial Services Act 1986, was regarded as one that had been rushed through Parliament. In contrast Labour's financial reforms were deliberately and carefully staged. While the broad outlines were announced within days of Labour assuming power in 1997, and the shell of FSA created soon after from the existing Securities and Investment Board, the enabling legislation came later in the form of the Financial Services

and Markets Act 2000. Notably a draft bill was introduced in 1998, and the government announced a period of consultation with all stakeholders over two parliamentary sessions, including a review by a joint committee of the two houses of parliament. The intent was to get things right.

The principal objection from the City to the draft bill was that it gave too much authority to the FSA (making it the 'prosecutor, judge and jury'<sup>17</sup>); that its proposal to impose unlimited penalties for poorly-defined categories such as 'market-abuse' amounted to a draconian restriction of the free-markets approach. It was claimed that introducing such regulation in the UK would undermine the City's competitive advantages and possibly reverse the spectacular gains achieved in the post Big Bang period. In response, numerous amendments were made, essentially diluting the regulatory powers and also inserting checks and balances, arguably lightening further the already announced light touch of regulation.

There was the related issue of the size and administrative budget of the new regulatory authority. The emphasis on light-touch regulation made a case for a smaller body. The consolidation of previously-fragmented regulation was intended to generate efficiency savings, by avoiding duplication of tasks and due to economies of scale and scope in supervision. About 450 regulators had moved en masse from the supervision department of the Bank of England to the newly created FSA. Others came from existing self-regulatory and other professional bodies.

It is certainly the case that the total administrative costs of financial regulation in the UK were low, both in absolute and comparative terms. Jackson (2007) notes that in 2004 the FSA employed about 3000 regulators, low in comparison to the US, where the various federal and state agencies employed about 30,000 employees; the UK number is lower even if we allow for the smaller size of UK's economy or its financial sector. As Jackson documents, regulatory cost per billion dollars of GDP was \$426,000 in the US but only \$277,000 in the UK. There was a particularly notable contrast between the regulatory budgets for supervision of banking, which was \$247,000 per billion dollars of banking assets in the US, but only £18,000 in the UK.

It is worth stressing just how low these figures are. Charges for intermediation services, expressed in basis points (i.e., 100ths of a percent of assets), range from, at the lowest, 30 to 40 basis points for minimal services such as tracker funds, up to several hundred basis points for some wealth management services. Bank profits alone typically absorb around 100 basis points of total assets. By comparison if we assumed a world in which regulation was supplied at a notional competitive price, the equivalent charges would be just 2.5 bp for the US, and a tiny 0.2 bp for the UK. It is very tempting to cite the old joke that 'if you pay peanuts, you get monkeys'.

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<sup>17</sup> 'Dangerous Watchdog', *The Economist*, 21 Jan 1999

This low cost approach was not just an outcome, but a feature of regulatory design: as FSA (2011) points out, as late as 2005, the Chairman of the FSA was at pains to reassure the Prime Minister that the FSA applied to the supervision of its largest banks only a fraction of the resource applied by US regulators. While this undoubtedly reflected some efficiency gains from consolidation, later events suggest that these economies may have severely constrained regulatory intensity.

## **V. How did the new regulatory structure cope with the financial crisis?**

The adequacy of UK's regulatory structure was not seriously tested until the financial crisis that started in 2007. The origins of financial market turmoil are usually traced to the collapse in prices of the securitised sub-prime mortgages market, a class of securities with performance tied to the continued rise in real estate prices. A down-turn in house prices made many of these mortgage-backed securities 'toxic'. The degree to which any financial institution was exposed to such assets was largely unknown, which created a great deal of uncertainty in the financial system. Liquidity in the interbank market for funds dried up, short-term interest rate spreads spiked. With the emergence of problems in the mortgage-backed securities market and related markets (e.g., the market for credit default swaps), there was a rapid contraction in the 'repo market', in which asset repurchase agreements effectively allow borrowers to raise money using securities as collateral. Gorton (2010) notes that this contraction shared many of the features of a classic bank run. Lenders also started demanding higher 'haircuts' (the percentage difference between the value of the underlying collateral and the amount borrowed). This restriction on borrowing left some institutions no choice but to liquidate assets at fire-sale prices, exacerbating their losses and therefore leading to even more severe haircuts.

We explore the impact of the crisis on the UK, and the role of financial regulation, by focussing on two key events: the collapse of Northern Rock in 2007, and the recapitalisation and support for Royal Bank of Scotland group and Lloyds in 2008.

### **(a) The Northern Rock crisis**

As a mutually-owned building society, Northern Rock had traditionally made mortgage loans financed by members' savings. After demutualization in 1998, its assets grew rapidly from £17.4 billion to £113.5 billion in 2007, making it the fifth-largest bank in the United Kingdom by mortgage assets. However, as Northern Rock expanded its mortgage assets, its balance sheet far outstripped its traditional funding base of branch-based retail deposits. Retail funding had been three-fifths of Northern Rock's liabilities in 1998, but had fallen to less than a quarter on the eve of the crisis in 2007. To finance this dramatic growth of its balance sheet, Northern Rock had increasingly come to rely on short-term



funding and the inter-bank market, to an extent greater than other UK financial institutions.

When these markets were hit by a liquidity crunch after the summer of 2007, Northern Rock was unable to renew its short-term loans: its wholesale funding, nearly £27 billion in June 2007, fell to less than £12 billion by December 2007. Northern Rock sought help from the Bank of England to solve a growing liquidity problem, but this was initially hampered by concerns about transparency, and by perceived legal constraints.<sup>18</sup> However the Bank did provide liquidity support (Liability to the Bank of England eventually rose to £28.5 billion) when Northern Rock's failure seemed inevitable, but the public announcement of this support triggered a much-publicised bank run among its retail depositors – the first in the United Kingdom since the 19<sup>th</sup> Century.

It was rational for depositors to withdraw their funds, given that official deposit protection in the United Kingdom was only partial: in the event of Northern Rock's failure, they stood to lose 10% of their savings beyond the initial £2000, and everything over £35,000. However Shin (2009) argues that the episode did not correspond to the standard model of a bank run: it was not so much a run by individuals, but rather by sophisticated institutional investors who faced tighter capital constraints, especially as many of them were trying to meet higher capital requirements due to increased riskiness of their own portfolios. Northern Rock's assets were illiquid long-term mortgages, so that it could not contract its balance sheet readily. By the time retail depositors began to withdraw, Shin argues, the damage had already been done.

The three aspects of the new regulatory structure that we identified earlier may all have contributed to the crisis at Northern Rock:

- *A failure of micro-prudential supervision.* FSA's own internal audit report (FSA, 2008) found inadequacies in the supervision of Northern Rock. As a result of internal reorganisations in the FSA, till June 2006 (and possibly till as late as February 2007), Northern Rock was supervised by a department whose primary responsibility was for insurance groups rather than banking supervision. The supervision process itself was not informed by any financial analysis which have revealed risks in Northern Rock's financing model. Where risks were identified, those risks were not effectively pursued, and these lapses blamed on high turnover of regulatory staff and shortage of expertise in prudential banking. Given the extremely low resource base of the FSA noted above, this cannot be viewed as surprising.
- *The partial nature of deposit protection.* This provided the immediate trigger for the run by retail depositors. When faced with a run, the incentive for every individual to withdraw one's deposits was very strong, and indeed, as

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<sup>18</sup> See the testimony of the Governor of the Bank of England to the House of Commons, 20 September, 2007, which cites legal difficulties due to the Takeover Code (which made a rapid takeover impossible) and the Market Abuses Directive in 2005, which ruled out covert lending.

Mervyn King admitted in evidence to a House of Commons Select Committee in September 2007, quite rational. The critical weakness, the only partial coverage of deposit protection, was corrected within days: protection was explicitly increased to 100% of deposits up to £50,000 (and more recently the limit has been raised further, to £85,000). We return to this issue in more detail in Section VI(c) below.

- *The tripartite structure.* The fragmentation of supervisory information and crisis-management tools, inherent in the tripartite structure, was bound to create loss of coordination in the event of crises. At the heart of the matter was a simple issue: while the FSA was responsible for supervision of individual banks, it lacked the tools to rescue a bank in trouble. The Bank of England had the ability to serve as the lender of last resort, but it lacked direct information about specific institutions and only a notional responsibility for financial stability. Without an obvious regulator to step in, regulatory inaction allowed the run to continue for three days before it was ended by the announcement of full depositor protection.

## **(b) Recapitalization of Royal Bank of Scotland**

The Royal Bank of Scotland had come to be regarded as a model of success in the new financial environment. As a relatively small financial player, but with considerable pedigree, it had grown rapidly over this period through acquisitions, most notably a hostile takeover of the much larger Natwest Bank in 2000. Its expansionary streak continued through much of the decade, acquiring a 10% stake in the Bank of China in 2005, and as part of consortium, participated in the takeover of ABN AMRO in 2007. Very briefly in the run up to the financial crisis, it had become one of largest banks in the world.

However this rapid expansion was achieved at some cost. Its expansion had been financed to a significant extent by debt, much of which was, like Northern Rock's short-term. It incurred significant losses in the credit trading (£18 billion over 2007-10, much of it in structured credit) and impairments on loans (£33 billion over 2007-10). By common consensus it may have overpaid for the acquisition of ABN AMRO, with little due diligence being exercised in the acquisition phase, and it was acquired with considerable reliance on debt, much of it short-term. Its capital position was too weak to absorb the losses on its trading activities, even though it met the low regulatory standards. The FSA did push RBS to recapitalise through a rights issue in 2008, but it was undersubscribed.

These troubles were not unique to RBS. As large classes of asset-backed securities lost value, several UK banks posted large losses and saw sharp falls in share prices. In April 2007, there were nine UK banks in the FTSE 100,<sup>19</sup> with a total market capitalization of £316.9 billion. By April 2008, two of the banks had

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<sup>19</sup> Alliance and Leicester, Barclays, Bradford & Bingley, HSBC, HBOS, Lloyds TSB (later merged with HBOS to create Lloyds Banking Group), Northern Rock, RBS, Standard Chartered.

dropped out of the index (Northern Rock and Bradford & Bingley), and the combined market capitalization stood at £245.1 billion. By April 2009 it had fallen further to £138.1 billion.<sup>20</sup>

The large losses underline the fact that the UK banking sector was experiencing a system-wide problem, and to avoid a full-blown systemic crisis, government support appeared inevitable. The Labour government responded by embarking on a large-scale programme of recapitalization and liquidity support for the financial sector in 2008. Indeed, the US and the UK governments were the first in the world to set-up a comprehensive set of measures to support the financial sector. These involved capital injections of over (ultimately) £45bn in the Royal Bank of Scotland and over £20bn in Lloyds Banking Group. Further, a Credit Guarantee Scheme was set up to guarantee short- to medium-term debt issued by eligible banks in the wholesale markets against a fee. This was intended to eliminate rollover problems, and to, in turn, restore confidence to the interbank market. Finally, at least £200 billion was made available to banks under the Bank of England's Special Liquidity Scheme. The scheme allowed banks and building societies to swap illiquid financial assets including mortgage-backed securities, for Treasury bills. At its peak, government support for the banking sector, both in terms of cash and in terms of contingent liabilities, exceeded £1 trillion.

To what extent was there regulatory failure? The FSA's (2011) report into the failure of RBS acknowledged some of its own failings: citing an 'inadequate focus on the core prudential issues of capital, liquidity, and insufficient willingness to challenge management judgements and risk assessments.' But it also concluded that the 'key prudential regulations applied by the FSA, and by other regulatory authorities across the world, were dangerously inadequate'. We pursue this (crucial) issue in the next section.

## **VI. EVALUATION OF LABOUR'S RECORD**

How did the regulatory and institutional structure created by the Labour government perform, especially in the face of the global financial crisis? In evaluating the regime, we distinguish between criticisms of flaws which, in our opinion, could have been avoided on the basis of knowledge and understanding that were available at the time, and lessons that can realistically only be drawn with the benefit of hindsight.

The visibly significant change introduced by the Labour government was in the institutional and organisational design of financial regulation. We begin by discussing the case for and against the chosen structure and the problems that ensued from the choice, especially when it came to macroprudential regulation.

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<sup>20</sup> House of Commons (2009). Given that there had been several capital issues in the interim (including those by financed by the state, discussed below), bank shareholders in aggregate had made cumulative losses of at least £200 billions; while shareholders in some of the worst-performing banks had in effect lost virtually all of their initial investments.

Second, we discuss the conduct and content of prudential regulation under the FSA. Third, we discuss the problems with the design of deposit protection and exit rules, an area that received little attention under successive governments including Labour, but played a critical role in spreading financial turmoil in the UK banking sector during the recent crisis. Fourth, we briefly examine the performance of conduct regulation under the FSA. Finally, we attempt to assess who bore the direct financial costs of the crisis, and whether this experience has sent out the correct signals to financial market participants.

### **(a) Evaluating the regulatory structure**

The Labour government's major initiative in combining fragmented self-regulatory bodies into a single statutory authority had some obvious advantages in eliminating unnecessary overlaps and free-riding incentives. However, the transfer of bank regulation from the central bank, and combining the prudential regulation of banks with conduct-of-business regulation in a unified body, merits scrutiny. Significantly, while supervision of banks was handed over to the FSA, the task of maintaining financial stability remained notionally with the Bank of England.

This begs the question, what are the elements of an ideal arrangement, especially as practice in this area varies across countries.<sup>21</sup> Goodhart (2000) addresses this question directly. There are several arguments for hiving off bank regulation from the central bank, a practice adopted in many countries.<sup>22</sup> As evolution of financial markets has blurred the distinctions between different kinds of financial activities – with, say, universal banks carrying out a range of transactions that span commercial and investment banking, and from insurance to mortgage lending – it seems natural that such financial conglomerates be regulated by a single regulator. In theory that unified regulatory task could be located within the central bank, but this may carry the risk that the central bank safety net would stretch to cover ever-widening range of financial activities. Further, where the central bank acquires operational independence in monetary policy, as the Bank of England did in 1997, the retention of supervisory functions may create conflicts of interest.<sup>23</sup> There may also be concerns that the

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<sup>21</sup> The regulatory landscape in the US provides a contrasting example. As Davies and Green (2008) summarise, there are over one hundred different regulators for the financial sector at federal and state levels. Even bank regulation is fragmented. A bank may be regulated by the Federal Reserve, the Office of the Controller of the Currency, the Office of Thrift Supervision, or one of fifty state banking regulators. In addition, banks must be members of the Federal Deposit Insurance Corporation, which has a staff of 4500 to regulate banks to protect the fund, and directly supervises 5000 state-chartered banks that are not part of the Federal Reserve System. Further, credit unions are regulated by the National Credit Union Administration, and have a separate deposit insurance corporation. It is possible to argue that having many regulators encourages free-riding and lowers standards. On the other hand, a fragmented structure is less likely to be subject to regulatory capture, and therefore might result in more aggressive regulation.

<sup>22</sup> In the eurozone this happened automatically, with monetary policy being carried out at the federal level, while banking supervision remained at the national level.

<sup>23</sup> For example, the monetary policy division might call for tighter policy, but this might be seen as detrimental to financial institutions by its regulatory division.

combination of monetary policy and bank supervision vests too much power in a body that is not elected.<sup>24</sup>

On the other hand, as Taylor (1995) argued, prudential regulation and consumer protection objectives require very different styles of regulation and ideally should be separated to create what he called a “twin-peaks” structure. In this approach prudential regulation requires a ‘doctor’s approach’ in trying to preempt problems, while consumer protection requires a ‘cop’s approach’ investigating after a problem has occurred. A second argument in favour of such functional dichotomy hinges on the need for smooth information flows: if lender-of-last-resort functions in the event of a crisis has to be provided by the central bank while bank supervision is delegated to an external regulator, the incomplete transmission of information between the two agencies may lead to a delay in the central bank’s policy response, undermining stability.

On balance there is no compelling argument in favour of one structure or the other. However, any chosen structure must consider the design of incentives, especially a clear demarcation of responsibilities. The implementation of the structure chosen by the Labour government in 1997 may well have fallen short.

First, the tripartite system required a clear division of responsibilities between the FSA and the Bank of England. In the absence of a clearly-identified macroprudential regulator, this tripartite structure, with seemingly overlapping responsibilities for systemic stability arguably allowed an ‘underlap’ on systemic stability. As a result, regulation and supervision aimed at promoting systemic stability was largely missing. Even taking into account the fact that the endogenous mechanisms capable of amplifying financial problems were not fully appreciated at the time, not giving any organization a clear mandate as a macroprudential regulator constitutes an important failure.

Further, as the current chairman of the FSA Lord Turner acknowledged,<sup>25</sup> the FSA developed a predominant focus on consumer protection to the detriment of prudential regulation.<sup>26</sup> As the Annual Report of the FSA (2011-12) admits, their “pre-crisis approach to prudential supervision was flawed, with insufficient resources devoted to the most important high-impact firms and inadequate focus on the core prudential issues of capital, liquidity and asset quality.” Our discussion of the Northern Rock and RBS episodes provides specific instances of such failure.

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<sup>24</sup> As Davies and Green (2008) note, the FSA was given responsibility for bank regulation because the Treasury was worried that an independent Bank of England that combines both monetary policy functions as well as regulatory powers would be too powerful. In describing the fragmented regulatory structure in the US, they also note that a single regulator is likely to be too powerful for Congress.

<sup>25</sup> House of Lords (2009).

<sup>26</sup> Given that consumer protection (the ‘cop role’) is largely a lawyer-driven activity, while prudential supervision requires economists (in the “doctor” role), an organization combining these is likely to end up with too much focus on one side and underperform on the other.

In sum, the tripartite arrangement seems to have been set up without proper care about the design of incentives for prudential regulators, and constitutes a significant failure of the organizational redesign under Labour. The post-crisis reforms represent a return to the twin peaks structure, with the creation of a Prudential Regulation Authority within the Bank and a Financial Conduct Authority to assume the other tasks currently carried out by the FSA.

### **(b) Evaluating microprudential regulation**

While the FSA has acknowledged its failings in carrying out its responsibilities as a microprudential regulator (as in the case of Northern Rock), in other cases the prevailing regulatory rules were themselves inadequate (as in the case of RBS).

The Basel I and II requirements specified a requirement of 8% capital ratio, out of which only 2% needed to be core tier 1 capital (common equity, retained earnings), which constitutes the highest quality capital in terms of loss absorbing capacity. While the UK regulator's trigger ratios for overall capital have usually been set above the Basel ratios, and the FSA encouraged banks to have capital above the minimum triggers, there was no higher minimum set for core tier 1 capital. As the crisis made clear, 2% high quality capital is too little, especially for systemically important banks. Shin (2009) and Adrian and Shin (2008) argue that common equity plays a crucial role, since the market value of equity can be effectively wiped out even if a bank does not become insolvent.

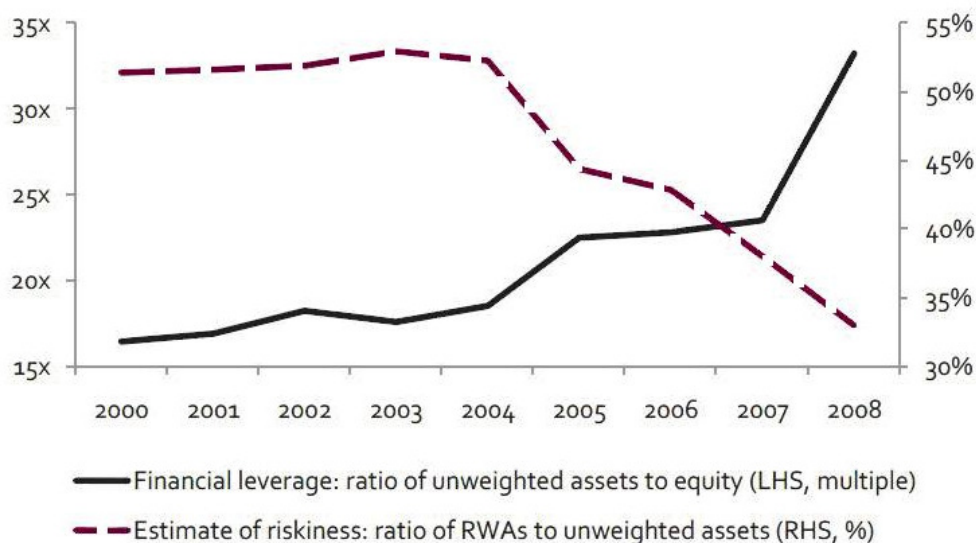
A further criticism is that, while bank-specific trigger ratios were set by the FSA, macroprudential concerns had no influence on regulation. Indeed it can be argued that the stance of policy was perverse, in that there was no systematic upward adjustment for systemically important banks. Indeed, the reverse seems to be true – the FSA's policy of (informally) encouraging banks to hold more capital than the trigger seems to have more success with smaller banks. Francis and Osborne (2010) show that, while UK banks all had capital ratios well in excess of the Basel minimum of 8%, larger banks typically had the lowest ratios. Clearly, with (and even to some extent, without) hindsight, proper macroprudential regulation would have corrected such an imbalance, and would also have raised the core tier 1 capital requirement for systemic banks.

However, we should also ask whether the UK regulator could have significantly altered the picture. It is worth remembering that regulation before the crisis was conducted in what was perceived as a benign economic environment, with the UK experiencing one of the longest stretches of sustained and stable growth in the postwar era (widely referred to as the "Great Moderation"), in which the then Chancellor Gordon Brown claimed to have abolished the business cycle. On the regulatory front, the new Basel II framework, introduced in the UK in 2006, was believed to have addressed the shortcomings in Basel I. Added to this was the widespread belief that financial innovation had made the system as a whole much more stable so that systemic stability was not a significant regulatory concern. Thus, as late as early 2007, the Bank of England's *Financial Stability Report*, while acknowledging the warning signs from the sub-prime market, asserted 'The UK financial system remains highly resilient'.

In such an environment if UK alone had raised capital requirements significantly, UK-based banks would have complained bitterly (and probably effectively) that their competitiveness was being put at risk by a heavy-handed regulator. Further, raising capital requirements would have been subject to the “Boundary Problem” described in Section II: it is likely that banks would have responded by yet more shifting of activities into the shadow banking sector, and further creative risk-management to produce even lower risk-weights on its assets.

This brings us to another issue – that of risk measurement. There was a significant failure in this regard by regulators on a worldwide basis, not just in the UK. Figure 1 shows that, for the four largest UK banks, as leverage grew, risk-weighted assets grew more slowly than unweighted assets. This is an example of Goodhart’s law whereby any targeted indicator, by virtue of being targeted, becomes useless. Given that regulators were targeting risk-weighted assets, this measure became largely useless as an indicator of the financial risk carried by a bank. However, these measurements were generated by an internationally agreed regulatory framework, and it is difficult to apportion any specific blame to the UK regulator.

**Ratio of risk-weighted assets to unweighted assets falls as financial leverage increases (aggregated for the four largest UK-headquartered banks)**



Source: Financial statements of Barclays, HSBC, LBG and RBS

**Figure 1**

Source: Independent Commission on Banking, Interim Report, April 2011

Finally, the crisis has also shown that regulation failed to allow for the importance of liquidity, both on the asset side (holding sufficient liquid assets)

and on the liabilities side (reduced reliance on short-term funds). Regulation of liquidity was not part of Basel II; neither did the UK regulator pay attention to potential liquidity problems faced by banks. But again, this was the norm internationally, and it is hard to single out the UK regulator for blame.

In the aftermath of the crisis, the Basel Committee suggested that under Basel III, while the capital requirement would remain at 8% of risk-weighted assets, the mix of required capital would change so that core tier 1 capital would increase from 2% to 4.5%, and rise to 9.5% for the banks with most systemic importance (as, for example, RBS would have been in 2008). New regulations on liquidity have also been proposed under Basel III. While these changes in Basel conventions would clearly have given greater protection in the last crisis, these changes bear all the hallmarks of a classic shutting of stable doors after the horse has bolted; and it remains to be seen how effective they will be in the next crisis. Haldane (2012) notes that regulated capital ratios pre-crisis would have given absolutely no signal of which banks were most in danger of getting into trouble.

### **(c) The design of deposit protection and exit rules**

A further aspect of New Labour's reforms of financial markets and their regulation relates to the mechanism for compensating individuals in the event of financial failures. As Demirgüç-Kunt et al (2008) describe, most developed countries have a deposit guarantee scheme, though they differ in terms of the scope and extent of their coverage, and also the funding mechanism. The design of deposit protection in the UK was however not fit for purpose. In part this inadequacy reflected some complacency, given the low level of bank failures in recent history. But it also captured a basic failure in understanding economic theory, a failure that proved unnecessarily costly in aggravating financial turmoil in the UK during the recent crisis.

When the Labour government took office in 1997 customer protection in the UK was through a collection of sector-specific schemes. Retail deposits in UK banks were protected by the Deposit Protection Scheme, under the Banking Act of 1979. Savings in building societies had a separate protection scheme. Individual investors were protected against failure of investment firms (but not, of course, against capital loss) under the Investors Compensation Scheme.<sup>27</sup> Insurance contracts were protected under the Policyholders Protection Scheme. Given that the FSMA 2000 sought to consolidate the regulation of all financial intermediaries under a single authority, namely the FSA, there was a natural case

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<sup>27</sup> The UK's original Deposit Protection Scheme was administered by a Deposit Protection Board, a statutory body whose membership was drawn entirely from the Bank of England. Under the original UK scheme, each depositor was covered for up to 75% of deposits up to £10,000. This limit was raised to £20,000 in 1987, and the fraction covered was raised to 90% in 1995 (see Jackson, 1996). The Building Societies Investor Protection Scheme, established by the Building Societies Act 1986 offered levels of protection similar to those in the deposit guarantee scheme. The Investors Compensation scheme allowed an investor to recover 100% of the first £30,000 and up to 90% of the next £20,000. Over the period 1988 to 1997, 340 firms were declared in default and net payouts were of the order of £111 million.



for consolidation of consumer protection too. FSMA 2000 put all these schemes under a common umbrella, the Financial Services Compensation Scheme.

A striking feature of all pre-existing protection schemes was the relatively small value of aggregate payouts. Over the period 1982 to 1996, aggregate net payouts from the Deposit Protection Scheme for UK banks were only £88 million; while not a single payout was ever made on the equivalent scheme for building societies. Compare this to the US figure where payouts over the period 1986 to 1995 were of the order of \$30 billion: a massive contrast even correcting for the relative size of the two economies. Given this background it is perhaps unsurprising that a degree of complacency may have led to the neglect of key features in the design of deposit protection schemes in the UK.

Two features of the UK scheme are particularly relevant to our discussion. First, and crucially, protection under the UK schemes was generally less than complete: for instance, depositors in a failed bank would recover say, 90% of their deposits in some range, rather than the full value of their entire holding. This 'co-insurance' was viewed as a deliberate design feature of these schemes in order to maintain a balance between consumer protection and *caveat emptor*. The explicitly-stated intention was to preserve depositors' incentives to monitor directly the soundness of firms that they dealt with. The desirability of maintaining only partial cover was reviewed by the FSA at the inception of the FSCS. While the coverage limits were adjusted – deposit protection for bank deposits was enhanced to cover up to 100% of the initial £2000, and then 90% up to £35,000 – the element of co-insurance was deliberately preserved (FSA 1997), and re-affirmed as late as 2005.<sup>28</sup> Since most (perhaps all) depositors would not want to lose 10% of their deposits in the event of failure, if a run on a bank is anticipated, it was rational for all depositors to withdraw their funds, making a panic-triggered bank run a self-fulfilling prophecy.

Second, on the arrangements to fund compensation payments, the UK schemes were almost entirely designed to be pay-as-you go rather than pre-funded. In most countries schemes operate as a form of mutual insurance so the cost of, say, a bank failure is borne by the surviving banks. But this cost can be passed on by creating an ex ante fund to meet future payouts or an ex post levy after the event of bank failure. Under the UK arrangements, compensation payments were to be met through a levy imposed on other banks ex post, though the FSCS does maintain a small fund to finance its administrative expenses and, since levies are normally imposed every 12 months, to ensure speedy compensation in the event of small failures in the next year.

By contrast, consider the Federal Deposit Insurance Corporation (FDIC) in the US which is required by law to maintain a substantial Deposit Insurance Fund. Under current legislation, the target value of the fund is 1.35% of the insured funds: a ratio which is in a similar ballpark to the Basel II Tier 1 capital ratio. In part this reflects the very much higher incidence of payouts in the US system,

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<sup>28</sup> As FSA (2005) puts it, 'The UK authorities believe that allowing consumers to bear an acceptable level of the cost should an institution fail, represents a proportionate way to address moral hazard.'

noted above. Additionally the premia collected by the FDIC are risk-based – banks are placed in one of nine categories, with significant variation so that banks that are deemed to be risky pay higher premia rates on their assessed deposit base. While risk assessments may be less than perfect, this arrangement provides at least some deterrence against banks' assumption of risk.<sup>29</sup> An ex ante fund also can correct for cyclicalities, transferring compensation resources from good times to bad ones: the funds of the FDIC were run down in the recent crisis, but are required to be built back gradually over time. Many of these design features were well-understood at the time the FSCS was being designed in the UK: see, for instance, FDIC (1998), so these criticisms do not solely rely on hindsight.

Why do these features matter? While partial coverage can preserve some incentives for depositors to exercise effort in monitoring financial firms, it beggars belief that individuals can be sufficiently informed about financial institutions in settings where even the FSA, with access to statutory powers to demand disclosure, was unable to do so. Recall that the primary purpose of deposit protection is not just compensation of individual investors in the event of bank failures, but the role that the promise of compensation can play in eliminating inefficient panic-induced bank runs. In other words, it is a measure to shore up confidence in banks. Providing complete deposit protection (up to a reasonable limit) is critical for this function. In other words, a scheme that is designed to only give partial deposit protection fails to eliminate the possibility of a bank run, and therefore fails in its principal objective.

The absence of proper exit rules in the UK was a further contributory factor in the depositor run on Northern Rock. In the US, the existence of a large fund enables the very rapid takeover of failed banks. While the US has had many failures, the ability of the FDIC to take immediate control of a failed bank implies that customers maintain continuous access to their funds. The UK scheme promised only to compensate customers within three months, a period that may be too long and disruptive. Such a flaw again undermines confidence: faced with the prospect of a loss of access to funds for a long stretch of time, depositors might prefer to withdraw funds, again leading to a run. The FDIC scheme is arguably designed on the assumption of (controlled) failure of banks as a regular occurrence while, at least until the recent crisis, the UK system treated bank failure as very low probability event.

Further, imposing charges on other banks to pay for failure of a bank would provide some incentive to control risks if there is any scope for banks to monitor their peers (as in a village cooperative scheme). But we are not aware of any evidence that banks have any exclusive information on other banks (information that is not available to the market) or that any such monitoring takes place. In the absence of monitoring incentives, the scheme simply induces a negative externality of a bank failure on other banks, implying socially excessive failures.

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<sup>29</sup> The FSA's arguments for co-insurance, for example, cited the need to deter investors from putting deposits into banks offering high returns, reflecting high risks – the Icelandic banks being, with hindsight, a prime example. However, risk assessment by a deposit protection scheme could arguably have fulfilled the same function more effectively.

The US model which charges a premium to any bank that not connected with any specific event of failure would seem to generate better incentives in this regard.<sup>30</sup>

These design flaws were transparent in the run by depositors on Northern Rock. Once the announcement of Bank of England's liquidity support came to be regarded as 'bad news', the incompleteness of depositor protection and the possibility of temporary loss of access to funds made a run rational for most depositors. While the run was not a large event in terms of the sums of money involved, it dented public confidence in the safety of banks, and damaged the regulatory reputations of the FSA and the Bank of England as well as the Treasury. In the aftermath of the run on Northern Rock, deposit protection levels were rapidly boosted to cover 100% of the first £50,000 (and further raised to £85,000 after 2011).

Clearly, the designers of the UK scheme did not understand the purpose of deposit protection, and successive governments, the Bank of England, as well as the FSA failed to correct this basic mistake until after the damage had been done. Indeed it is arguable that things could have been much worse. The government and the Bank of England's response, albeit belated, to the run on Northern Rock, may well have forestalled potential, and much larger runs, on other banks later in the crisis.

#### **(d) Conduct regulation under the FSA**

By design, the FSA devoted considerable resources towards conduct regulation, possibly to the detriment of prudential regulation. However, even on the regulation of financial conduct, the FSA's record is far from stellar. Its statutory objectives in this area included consumer protection and reduction of financial crime and, on both fronts, its record is mixed.

Better consumer protection was one of the avowed objectives of regulatory reinforcement under FSA. Indeed, New Labour's 1997 manifesto explicitly mentioned the need to eliminate practices such as 'mis-selling' of personal pensions (infact, this was the sole issue on which financial reform found mention in the manifesto). A series of previous and brewing scandals call into question FSA's focus on this objective. It did impose financial penalties on firms involved in some types of 'mis-selling'—the aggressive selling of financial products that were not suitable for all customers—such as fines on Lloyds TSB for mis-selling the so-called precipice bonds. It assumed regulation of general insurance relatively late, in 2005, but seems to have done little in the initial stages to check the mis-selling of payment protection insurance (supplementary insurance link to credit contracts that intends to protect repayments in adverse events, but typically very expensive and riddled with hidden exclusion clauses). The FSA also dragged the feet on the issue of excessive bank charges for customers who had

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<sup>30</sup> This does of course beg the question whether administrators of the scheme would be able to identify risks of particular banks. See, for instance, Haldane's (2012) evidence of the complete lack of predictive power of pre-crisis risk metrics.

overdrawn on their accounts, an issue that was pursued more actively by the Office of Fair Trading.

FSA's record on prevention of market abuse and financial crime too shows a mixed trajectory. It did impose a £17m fine on Shell in 2004 for market abuse, and there were other financial penalties, but its light-touch approach meant that such instances were not that many. This is especially the case when it came to restraint of insider dealing. Its own analysis (FSA, 2006) found evidence of unusual price movements prior to a quarter of merger announcements<sup>31</sup>, but there was limited enforcement and till as late as 2007, restricted to imposition of civil remedies rather than deployment of its authority to impose criminal sanctions.<sup>32</sup>

### **(e) Quantifying the cost of the financial crisis**

Who paid the price for the financial crisis? This is conceptually and practically a difficult question. We initially restrict our attention to the direct, i.e., first round costs, associated with failures, or near-failures, of UK banks. On this basis, at least, the summary picture is fairly clear. The greater part of the costs was borne, as indeed is the clear intention of banking regulation, by the banks' own shareholders. Costs to UK taxpayers were however also significant (and their ultimate value remains hard to quantify). In contrast, retail deposit-holders escaped largely unscathed, and bondholders largely managed to free-ride on deposit protection.

Taxpayer costs of the bailout have been investigated in some detail by the National Audit Office (NAO, 2012): we provide a summary of their figures in an appendix. Taxpayer support came essentially in three forms:

1. Loans
2. Contingent liabilities
3. Direct equity investment

In the appendix we show that, on the basis of NAO figures, it appears that, at least ex post, the first two categories have not resulted in significant losses to the taxpayer. It appears reasonably likely that most loans (the bulk of which were to the remnants of Northern Rock and Bradford & Bingley) will be repaid, with cumulated interest at a rate that will have covered the funding costs of the additional government debt. And, while contingent liabilities (in the form of a range of government guarantees) peaked at over £1 trillion in 2008, they had already fallen to one tenth of this level by March 2012, and, with most such schemes likely to close in the relatively near future, it is quite likely that a negligible proportion of contingent liabilities will actually be exercised. Indeed,

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<sup>32</sup> FSA (2007), 'The FSA's approach to insider dealing, speech by Director of Enforcement, FSA, October 2007

the NAO estimate that, again, *ex post*, the taxpayer has made around £11 billion in fees charged for the scheme.<sup>33</sup>

The taxpayer has however almost certainly lost out in the provision of new equity capital, via purchases of shares, mainly in the Royal Bank of Scotland and Lloyds. In the Appendix we show that, as of March 2012, the market value of all taxpayer investments in shares of UK banks had, on NAO estimates, fallen by around £27 billions, or roughly 1% of GDP; and these investments had essentially generated no income to offset the funding costs of additional government borrowing.

Significant as these losses are, it is salutary to be reminded that they are at the low end in comparison with the international evidence of the taxpayer costs of bank bailouts summarised by Reinhart & Rogoff (2009).

More crucially, while the taxpayer did share the costs of the crisis, the greater part of the costs were borne by shareholders. By the time RBS was bought out, its market value had already fallen by 95% from its peak. Thus by far the largest part of the losses was borne by shareholders, predominantly pension funds, who lost (at least) £200 billions (or around 8% of GDP) between early 2007 and early 2009.<sup>34</sup>

In contrast, since virtually no UK banks (and no large ones) became officially insolvent, bondholders suffered only modest losses – and these were essentially restricted to those holding subordinated debt or preferred equity. This immunisation from losses begs the question whether the UK's tradition of preventing banks from legal (as opposed to *de facto*) insolvency achieves the right incentive effects.<sup>35</sup>

Thus, at a crude estimate, the direct costs of the UK banking crisis to “stakeholders” (i.e., totalling costs to taxpayers, shareholders and bondholders) was of the order of around £250 billions, or roughly 10% of GDP. To put this in context, at current valuations, an equivalent loss (or gain) would be realised to investors in the UK stock market if it fell (or rose) by 14% - less than a standard deviation on an annual basis. This raises the intriguing question (beyond the scope of this paper) of why losses due to bank crises (which are, it should be recalled, redistributive, rather than actual losses) should have such large apparent effects on the economy as a whole.

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<sup>33</sup> It is much more difficult to assess whether these fees charged were, *ex ante*, commensurate with the risks borne by the taxpayer: the NAO conclude that there was an implicit subsidy of up to £5 billion.

<sup>34</sup> This figure needs more precise calculations, which will be updated in the final version of the paper, but is predicated on the decline in market value, cited above, from £317bns, to £138bns, where the latter figure had been boosted by (at least) £45 billions of new issues.

<sup>35</sup> There are interesting contrasts both with the US and the experience of the Icelandic banks, whose depositors received 100% protection (albeit initially courtesy of the UK government) but whose bondholders suffered losses of roughly 40 billion euros. In consequence of passing losses on to bondholders, the liquidation of the Icelandic banks' portfolios looks likely to realise enough to repay the UK government.

## VII CONCLUSIONS

To what extent did UK regulatory design under Labour meet the broad objectives of financial regulation set out in Section II of the paper? And, given that enforcement was delegated to the FSA, to what extent did it fulfil the task that was assigned to it?

On the microprudential front, the UK did successfully implement a stronger version of the international benchmarks set out in the Basel proposals. With the benefit of hindsight we now know that, as set out in Section VI b) of this paper, these international standards turned out to be inadequate, especially when it came to measurement of risk. Put simply, the risk characteristics of new classes of financial assets – for example, asset-backed securities – were poorly understood by regulators around the world. The FSA’s failure, shared with other regulators, stemmed from excessive faith in these standards and ignoring other danger signals. For instance, as described in Section V of the paper, Northern Rock’s excessive reliance on short-term wholesale funding to expand its balance sheet posed risks that were not checked by capital requirements alone, and self-admitted weaknesses in FSA’s monitoring and supervision process made the discovery of these risks unlikely. In the case of Royal Bank of Scotland, similar problems were compounded by its aggressive strategy of debt-funded acquisitions, a strategy whose soundness was beyond the regulatory remit of the FSA. With hindsight, RBS represents by far the largest failure of regulation in quantitative terms, as measured by losses both to shareholders and to the taxpayer.

Even as the FSA underestimated the risk of failure of individual institutions, its mechanisms to cope with actual failures was limited. The design of the financial services compensation scheme (FSCS) was concerned primarily with harmonising consumer protection across various classes of financial activity, from bank deposits to general insurance. It ignored the fact that the purpose of consumer protection varies widely across these activities (see Section VI c)). In particular, the designers of the FSCS did not appreciate that partial coverage of retail deposits could leave the system vulnerable to bank runs. The construction of FSCS, notably its lack of complete protection and ex ante funding, revealed ignorance both of contemporary economic theory and of practice in other countries. The blame for this must be shared by the government, the Bank of England, and the FSA. The failure of deposit protection arguably did much to dent confidence in the early stages of the financial crisis.

On the macroprudential front, the tripartite structure that Labour created did not have an unambiguous assignment of this regulatory objective (see Section VI a). Notionally the Bank of England had a role in the maintenance of financial stability, but once removed from day-to-day banking supervision, it became blinkered to the emerging systemic risks, except perhaps to the extent that these risks affected its primary responsibility of maintaining monetary stability. However, we must not overstate this weakness: countries that did not have such separation, such as the US, did not fare better.

This begs a larger question: can regulation prevent crises at all? If we admit the possibility that the self-interest of financial players is not sufficient to prevent their failure, or prevent individual failures from morphing into systemic crisis, can well-designed regulation mitigate these risks?

The history of UK regulation under Labour is a good illustration (as are the experiences of most, if not all, other major economies) of the difficulty of regulating a complex and continuously innovating system. Regulation can at best hope to control risk in the system using crude measures; and even when the choice of measure seems sensible, it is vulnerable to Goodhart's Law: namely, that any regulatory target is likely to be gamed by the regulated entities, thus reducing the information content of the target, possibly to zero. Since the financial crisis, alternative risk measures have been proposed – such as the raw leverage of financial institutions – which, with hindsight, might have done a better job than the measures actually employed before the crisis. But it is easy to imagine that any alternative measure might well have spawned its own distortions.

There is also the issue of the boundaries of regulation. The very act of regulation inevitably creates incentives for the relocation of activities outside the reach of the regulator. There was clear evidence of this phenomenon in the rise of the so-called 'shadow banking' sector during the 1990s and 2000s. Activities in the shadow banking sector tend to be similar to that in traditional banking, but the absence of regulation meant that these activities were more profitable in the upturn, but more vulnerable to loss of confidence in the downturn. While some have argued that, in light of this experience, systemic regulation should apply to all sources of systemic risk, implementing such policies would be likely to encounter major practical difficulties.

We would highlight two further lessons to be learnt from the experience of banking regulation under Labour.

First, if there *is* to be more effective regulation in the future, it will almost certainly require considerably more resources than were invested under the Labour regime. With hindsight, the "light-touch" regulation of this period simply meant that it was massively under-resourced (see Section IV c).

Second, the primacy accorded to regulatory concerns, as mediated by the political process, tends to vary with the economic cycle. When the economy is doing well, so does the financial sector. Regulators are typically unwilling or unable to take a very stringent stance as concerns about competitiveness outweigh prudential concerns, especially once the economic boom is legitimised by a 'this-time-is-different' mindset. A benign environment also makes for easier regulatory capture by a wealth-generating financial sector, again lessening the regulatory burden. The pattern of regulation under Labour bears all the hallmarks of such patterns of behaviour; but in all fairness, showed little if any difference from that of governments in other major economies. In the aftermath of a crisis, regulation is inevitably tightened (often over-tightened) to address the perceived problems in the previous market exuberance. The incoming Coalition government also appears to be following this typical pattern. But the clear risk is

that new problems will in due course arise that will again tend to render current regulation ineffective in preventing future crises.

On a more positive note, albeit not strictly under the purview of regulation *per se*, we would argue that, after a shaky start during the early – Northern Rock – stages of the crisis in 2007, the management of the financial crisis under Labour was, with hindsight, quite well executed. As documented in Section Ve) of the paper, the direct costs to the taxpayer, while non-trivial, appear (at least thus far) to have been limited to the costs of recapitalising two major banks. Crucially, by far the greater part of the costs of what has now been revealed to be reckless behaviour by some UK major banks was borne by shareholders in those banks.

As a final point, we should mention a Dog That Did Not Bark during the financial crisis that occurred under Labour. As noted in Section II, a very substantial proportion of financial intermediation occurs outside the banking sector: most notably via pension funds and unit trusts. These sectors were not, of course, immune to the impact of the crisis. The fall in the stock market in 2008 alone led to a reduction of the value of total investments of pension funds and unit trusts of \$228 billion,<sup>36</sup> a figure of a similar magnitude to the total losses in the UK banking sector that we summarised in Section V of this paper. But these losses were entirely borne (or will in due course be borne) by the ultimate investors; none were passed on to the taxpayer. Nor were these losses regarded as a failure of regulation or as a major risk to the financial system. The striking difference between the impact of these two very similar financial shocks on the economy, and on public policy, reflects fundamental differences in the nature of intermediation, as highlighted in Section II of this paper. The banking system, with its mismatch between the nature of its liabilities and its assets has, as documented by Reinhard and Rogoff (2009), been chronically prone to crisis. It seems unlikely that the Labour government's failure to fully anticipate the banking crisis of 2007-8 will be the last such occurrence we shall witness.

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<sup>36</sup> *Financial Statistics*, July 2010, Tables 5.1b and 5.2d



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