Financial Crisis—U.K. Policy and Regulatory Response

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Abstract

The purpose of this article is to outline the principal responses adopted within the United Kingdom to the recent financial crises beginning with the contraction in liquidity on inter-bank markets in August 2007. Earlier papers are referred to following the public acquisition of Northern Rock, including relevant House of Commons reports, and later House of Lords studies, although this article focuses specifically on the more recent recommendations contained in the important Turner Review, the United Kingdom Treasury White Paper on Reforming Financial Markets, and the Walker Review on Corporate Governance in the financial area as well as the structure and content of Banking Act 2009 and the government's most recent Financial Services Act 2010. The objective is to identify the key components within the emerging U.K. response, as well as residual gaps and omissions which study may be of interest and use to policy reformers, legislators, practitioners, and other interested parties in other parts of the world.

The global financial crisis that began in summer 2007 has continued to wreak devastating loss and damage across all markets, all economies, and all countries.1 An initial liquid-

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ity contraction in the financial markets was transformed into a full solvency crisis following the collapse of Lehman Brothers on September 15, 2008, which was a precursor to the most savage global recession since the Great Depression during the 1930s. This crisis was almost wholly unpredicted and led to a massive collapse in growth and investment across the world. Leading emerging markets were not immune as any possible decoupling or separation evaporated. It was not until the end of the second quarter of 2009 that some stabilization in the financial sector was detected. Any full recovery within the real economy would be postponed until 2010 or later.

A large number of official, technical, and private papers and commentaries have since been issued on the causes and failures that led to the collapse. An even more substantial number of recommendations for corrective action and reform have been brought forward to prevent any future recurrence. The core challenge nevertheless remains to identify the correct causes and fault, to ensure that the necessary lessons are learned, and the most appropriative corrective action taken. This objective necessarily includes many more specifically technical supervisory and regulatory amendments, although a number of more difficult substantive policy issues also remain to be resolved in certain key areas concerned.

The purpose of this paper is to consider some of the more significant documents issued in the United Kingdom following the crisis and to attempt to identify the more important policy issues raised. An influential paper was produced by Lord Adair Turner, the new Chairman of the Financial Services Authority (FSA), on The Global Banking Crisis in March 2009, which was followed by a Treasury White Paper on Reforming Financial Markets in July 2009. Sir David Walker released his report on Corporate Governance in UK Banks one week later with other financial stability institutional reforms within the Bank of England coming into effect earlier in the year under the Banking Act 2009. The Banking Act specifically established a new special resolution regime (SRR) for U.K. banks following U.S. restructuring models and provided for the creation of a new Financial Stability Committee within the Bank. The government also brought forward a proposal for a further Financial Services Bill in November 2009. Whether this would come into effect was to depend upon whether the labor administration, under Prime Minister Gordon Brown, won a fourth term in office following the General Election in May 2010, although the Financial Services Act 2010 was then quickly enacted on April 8, 2010. The key recommendations made within each of these documents are considered and the emerging U.K. policy response assessed.

I. Financial Crisis

Reports of rising defaults on sub-prime mortgage accounts in the United States in 2006 and early 2007 led to an initial contraction in wholesale credit markets between summer

5. HM Treasury, Banking Act 2009, § 1, 238.
2007 and summer 2008. Despite this, market tensions appeared to be manageable until the shock losses revealed at Fannie Mae and Freddy Mac, Lehman Brothers, and American International Group (AIG) in August and September 2008. The U.S. authorities were able to salvage the mortgage agencies by bringing them into conservatorship and AIG subsequently; although Lehman was forced to file for bankruptcy on September 15, 2008. This led to a collapse in financial stock prices across all major markets as the crisis escalated from being liquidity to solvency based. Stock markets tumbled during the third week of September and first week of October with little respite possible after the announcement of delayed agreement on the U.S. $700bn Troubled Asset Recovery Program (TARP). This followed a period of unsightly disagreement and compromise within Congress; with meaningful leadership also being absent within the European Union (E.U.) and at the G7/G8 levels. It was only following the forced intervention by the British government on the morning of Wednesday, October 8, 2008, that the rout in the United Kingdom and European markets was halted. This almost inspired intervention was based on a combination of capital injections (recapitalization), extended liquidity support through the Bank of England’s Special Liquidity Scheme (SLS), and government supported three-year wholesale (legacy) guarantees. This combination of capital, liquidity, and support guarantees subsequently became the basis for intervention in many other countries.

A. Northern Rock

Within the United Kingdom, the first casualty from the crisis was Northern Rock Bank. Northern Rock had only limited exposure to the U.S. sub-prime market of around £75m, although its business model made it dependent on wholesale funding through the U.K. inter-bank markets. Northern Rock had only 22.4% of retail cover with the rest of its funding coming from securitization, covered bonds, and wholesale borrowing, which disappeared with the contraction in wholesale lending. The bank was forced to accept emergency funding from the Bank of England on September 14, 2007, and after an untidy leak by reporters on the British Broadcasting Corporation (BBC) of its financial difficulties, its share price plummeted, which began the first run on a major U.K.
bank since Overend Gurney in 1866. The Treasury was forced to make repeated statements of assurance to the markets on September 17 and 20, 2007, and October 19, 2007. After an unsuccessful attempt to find a preferred private bidder (including by the Virgin Group, Olivant, and a potential management buyout team), Northern Rock was brought into public acquisition (nationalized) on February 17, 2008. The Banking (Special Provisions) Act was taken through Parliament quickly, and enacted on February 21, 2008, to facilitate the transfer. This was replaced by the permanent resolution provisions contained in the Banking Act 2009 exactly one year later. The former shareholders in Northern Rock commenced an action against the government for inadequate compensation before Lord Justice Stanley Burnton, although the action was dismissed in court at first instance, whose decision was upheld on appeal.

B. BRADFORD & BINGLEY

A second former building society, Bradford & Bingley, which had been converted into a bank in 2000, had also to be nationalized on September 29, 2008. Its savings operations and branches were sold to the Spanish bank, Santander, with the government assuming responsibility for its £50bn mortgage book. Bradford & Bingley had been one of the leading lenders in the higher risk buy-to-let and self-certification mortgage markets. Another building society, the Dunfermline, was later acquired by Nationwide Building Society in March 2009, after losses suffered following the recession had unfolded with other building societies mergers being forced through, including the Catholic & Chelsea, Cheshire, Derbyshire, and Nationwide Building Societies.

C. BANK SUPPORT PACKAGE

Following the announcement of the U.K. government’s recovery plan on October 8, 2008, each of the major U.K. banks was forced by the Treasury to recalculate their capital needs over the weekend using extreme stress tests devised by the Financial Services Authority (FSA). The government had promised up to £50bn in bank recapitalization, although only around £37bn was initially required, which was taken up by Lloyds RSB (£5bn), Halifax Bank of Scotland (HBOS) (over £12bn), and Royal Bank of Scotland.

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16. Walker, Credit Crisis–Regulatory and Financial Systems Reform, supra note 1, at 569; Walker, The Global Credit Crisis and Regulatory Reform, supra note 1, at 192; Walker, Northern Rock Falls, supra note 1, at 4-5.
17. Walker, Credit Crisis–Regulatory and Financial Systems Reform, supra note 1, at 569; Walker, The Global Credit Crisis and Regulatory Reform, supra note 1, at 192; Walker, Northern Rock Falls, supra note 1, at 4-5.
18. Walker, Credit Crisis–Regulatory and Financial Systems Reform, supra note 1, at 569; Walker, The Global Credit Crisis and Regulatory Reform, supra note 1, at 192; Walker, Northern Rock Falls, supra note 1, at 4-5.
20. Walker, Credit Crisis–Regulatory and Financial Systems Reform, supra note 1, at 569; Walker, The Global Credit Crisis and Regulatory Reform, supra note 1, at 192; Walker, Northern Rock Falls, supra note 1, at 4-5.
22. Walker, Credit Contraction, Financial Collapse and Global Recession, supra note 1, at 6-7.
23. Id.
24. Id.
25. Id. at 9.
(RBS) (over £19bn). The funds were made available through the Bank Recapitalization Fund (BRF), with the government acquiring twelve percent preference shares (in contrast to the six percent imposed in the United States). The other major banks were able to raise capital from the markets. The government had earlier approved the separate acquisition of HBOS by Lloyds before the bank recapitalization plan was announced in October 2008, with special competition dispensation having to be provided as the new Lloyds Banking Group (LBG) had acquired over thirty-two percent of the market in excess of the twenty-eight percent maximum permitted. Some argued that the acquisition agreed to prior to the recapitalization should not have been allowed to proceed following the making available of additional capital through the government scheme in October. This acquisition was no longer necessary and appropriate, although the government insisted that HBOS may still not have been able to survive by itself and that this was a commercial decision.

D. SECOND SUPPORT PACKAGE

With the onset of the global recession, further losses were suffered by the U.K. major banks, which forced the government to announce a second support package in January 2009. This announcement followed discussions on January 17-18, 2009, concerning the possible establishment of an asset purchase scheme based on the U.S. TARP model. Rather than follow the U.S. example, it was decided to establish an insurance scheme that would limit the losses on the highest risk distressed assets on the banks' balance sheets. This scheme was referred to at the insistence of the authorities as a "work-out," rather than a second "bail-out," in the press. The new Asset Protection Scheme (ASP) came into effect on February 26, 2009, with the Treasury providing credit loss protection on one or more portfolios of defined assets in excess of an agreed "first loss" amount, with ninety percent of the credit losses in excess of this amount being covered and institutions assuming liability for the remaining ten percent of loss.

E. POLITICAL AND PARLIAMENTARY RESPONSE

A number of official documents have been published in the United Kingdom in response to the crisis over the last two years in addition to the Turner Review, Walker Review, and Treasury White Paper. These parallel similar United States investigations, papers, and legislative reform packages. These documents include a series of papers by

26. Id.
29. Walker, The Global Credit Crisis and Regulatory Reform, supra note 1, at 194.
30. Id.
33. Id.
the Tripartite authorities (made up of the Bank of England, the Treasury, and the FSA) in 2007 and 2008. The Treasury issued a paper on international issues, and the Bank of England issued a separate paper on its money markets operations. A series of reports were produced by the House of Commons Treasury Select Committee, under its energetic Chairman John McFall, that included *inter alia* papers on financial stability, Northern Rock, transparency, bank supervisory reform, failing banks, Icelandic banks, bank remuneration, international issues, and "too big to fail." Two reports were produced by House of Lords committees on regulatory reform and the European regulatory architecture. The FSA had issued its own internal review on the supervision of Northern Rock on March 26, 2008, which led, in particular, to the establishment of a "Supervisory Enhancement Programme" (SEP). Further papers were issued on the creation of a parallel-enhanced liquidity regime with a model code on remuneration practices.

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National Audit Office (NAO) published its report on *HM Treasury: the Nationalisation of Northern Rock* on March 20, 2009. Other more specific or technical regulatory papers have also been issued by the U.K. authorities over the last two years.

II. Turner Review—March 2009

One of the most important documents published in the United Kingdom was the review on the *Global Banking Crisis* conducted by Lord Adair Turner, the incoming Chairman of the FSA, which was published on March 18, 2009. Lord Turner had been asked by the Prime Minister, Gordon Brown, to provide a report following his appointment in September 2008, on the origins of the financial crisis with an assessment of the regulatory deficiencies that arose, and to make recommendations for reform. Turner had outlined a number of the key ideas contained in the review in an earlier speech on the financial crisis in January 2009. This review followed other speeches by key FSA personnel on various aspects of the crisis including structured finance, investors, and deterrence.

The Turner Review considers the background to the crisis (Chapter 1 “What Went Wrong”) and the key regulatory lessons to be drawn (Chapter 2, “What to Do”). Other wider issues are referred to with regard to product regulation, counter-cyclical tools, and balancing liquidity and stability (Chapter 3), with additional comments on implementation and transition (Chapter 4). The FSA issued a further discussion paper in support of the Turner Review that expands on the issues set out in Chapter 2 with more specific discussion, background material, and questions for consideration. The main recommendations are restated with a note of the other regulatory agencies involved and proposed delivery dates (referred to as “implementation dependencies”).

The Turner Review generally rehearses and restates other regulatory initiatives already identified or commenced within either the United Kingdom or elsewhere. It nevertheless provides a substantive discussion of many of the key issues involved either in the report directly or supporting discussion papers. This discussion then creates a new intellectual basis for post-crisis regulatory reform and regulatory debate. It also announces several important new initiatives.


44. Turner Review, supra note 2.


46. Turner Review, supra note 2.

47. Id.


49. Id. at 118-122.
A. FINANCIAL CRISIS

The Turner Review considers the background to the crisis in terms of global conditions, U.K. developments, international regulation, and a series of further more specific theoretical issues. In terms of global conditions, the Turner Review focuses on the financial sector growth, increased leverage, changing forms of maturity transformation (and expansion of the “shadow banking” system), a misplaced reliance on modern risk management theory (referred to as maths), and “hard-wired procyclicality” created through ratings, triggers, margins, and haircuts.50

The examination focuses on the securitized credit market, which was intended to diversify and reduce risk rather than aggravate it. This market had been stimulated by substantial global macro-imbalances with low real interest rates and a search for yield uplift with the perception that the global economy had become less risky as part of a “Great Moderation” or “Great Stability” of risk management.51 Seven features are identified as characterizing the new financial marketplace with the massive growth in the scale and complexity of securitized credit intermediation, extensive commercial bank involvement in trading activities, increased leverage, new forms of maturity transformation, misplaced reliance on finance theory, and excessive reliance on ratings with inadequate bank capital buffers.52

The discussion of the crisis is possibly overcomplicated, which also confuses consequent factors (which follow from other conditions) rather than original causal factors behind the specific crisis that arose. A number of the factors identified relate to the conditions that aggravated the crisis or became more relevant after it had occurred. These conditions were not necessarily causal in themselves. The causes of the crisis were separately summarized by Verena Ross, Director of Strategy and Risk at the FSA, in terms of significant global macroeconomic imbalances over the last decade, the increased complexity in the securitized credit model, rapid extension of credit in the United States and United Kingdom, increased leverage, and an underestimation of bank and market liquidity risk, which corresponds with other writers’ formulations.53

B. REGULATORY RESPONSE

The Turner Review considers regulatory reform in terms of ten possible action areas including systemic control, accounting and liquidity, deposit protection and bank resolution, credit ratings, remuneration, derivatives clearing, systemic oversight, supervisory approach, prudential and conduct of business control, risk management and governance, commercial banking, and securities trading and cross-border banks within the E.U.54

This examination is based on its assessment of the crisis and theoretical issues identified. It is nevertheless accepted that many of the reforms will be dependent on European and international consensus.

51. Id. at 11-25.
52. Id. at 28.
53. Walker, Financial Crisis Cause and Correlation, supra note 1, at n.1 (summarizing the crisis in terms of massive accumulation of credit and debt, product innovation and disclosure, mispricing of credit risk and asset valuation, the co-mingling of risk, and lack of effect liquidity and market support).
54. Turner Review, supra note 2, at 51.
1. **Systemic Regulation**

The Turner Review recommends that a systemic approach be adopted for financial regulation.\(^{55}\) This policy is justified based on the maturity transformation of banks, the potentially systemic nature of banking liquidity risks, and the damage and consequences of bank system failure for the real economy. The paper identifies an inadequate focus on systemic risk and the sustainability of whole business models and failure to design regulatory tools to deal with systemic issues as being a major deficiency.\(^{56}\) While the review does provide an instructive clarification of regulatory policy, it is arguable that these deficiencies should have been the core objective of financial regulation historically. Consumer (depositor) protection and financial stability are traditionally identified as the principal justifications for financial regulation. While specific national authorities such as the FSA may have over-focused on individual bank (idiosyncratic) rather than market (systemic) effects, this justification can be criticized as being a misunderstanding of the core function of financial control on the part of the regulators.\(^{57}\) Specific markets should have been examined as a whole (and not just individual institutions in isolation) with the relationship between separate sectors also being taken into account especially as the U.K. FSA is a single regulator operating under an integrated regulatory regime set up under the FSMA 2000.\(^{58}\)

C. **CAPITAL AND ACCOUNTING**

The Turner Review considers that capital, accounting, and liquidity factors contributed to the origins of the crisis. Inadequate capital against trading book positions had allowed excessive leverage and maturity transformation changes increased system-wide liquidity risk with market-to-market accounting supporting a “self-reinforcing irrational exuberance,”\(^{59}\) with banks then having insufficient capital reserves to “absorb losses.”\(^{60}\) Leverage is, nevertheless, a factor of liquidity as well as capital, while the growth of securitized product markets necessarily increases trading or position risk. Stock market growth and market confidence arose from more general economic conditions rather than simple accounting measures.

The Turner Review draws seven specific conclusions in connection with the need to increase the quantity and quality of overall capital, raise trading book capital (by a further factor of three), avoid pro-cyclicality in Basel II implementation, create counter-cyclical capital buffers, offset pro-cyclicality in published accounts (with the inclusion of a new “Economic Cycle Reserve”), impose a gross leverage “backstop” ratio (of assets to capital), and strengthen liquidity supervision, and regulation (with a possible minimum “funding ratio rule”).\(^{61}\)

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\(^{55}\) Id. at 52.

\(^{56}\) Id. at 53.

\(^{57}\) Id. at 84.

\(^{58}\) M. BLAIR, ET AL., FINANCIAL SERVICES LAW 14 (2d ed. 2009).

\(^{59}\) Turner Review, supra note 2, at 25.

\(^{60}\) Id. at 53.

\(^{61}\) Id.
D. LIQUIDITY

It is generally accepted that liquidity risk management must be enhanced in the Turner Review. The FSA had issued a discussion paper on liquidity in December 2007, with a full consultation paper in December 2008, after the crisis, and separate papers on reporting and interim arrangements in April and June 2009.62 The later paper includes a requirement for the imposition of a detailed Individual Liquidity Adequacy Assessment (ILAA) and Individual Liquidity Guidance (ILG) with strengthened liquidity reserves and heightened stress testing.63 A further follow-up paper was then issued in October 2009.64

The FSA has also been considering whether a core-funding ratio should be imposed in addition to individual tailored liquidity measures.65 This ratio could use either simple loan-to-deposit ratios or more sophisticated core-funding calculations based on retail deposits and long-term wholesale funding as against total liabilities.66 A core-funding ratio may be used either as an absolute ceiling (backstop rule) or as an indicator to assess systems-wide risks and matters to be dealt with in Individual Liquidity Guidance (ILG).67

E. PRO-CYCLICALITY

The Basel II Capital Accord is specifically criticized in the Turner Review for its essentially pro-cyclical effects.68 One result is that banks are required to hold more capital where the creditworthiness of borrowers falls during a downturn, although it is arguable that this situation is precisely what should happen in light of the increased credit risk involved. The FSA has already introduced measures to require banks to use “through-the-cycle” estimates of possible loan losses (with “variable scalars”), rather than “point in time” measures, to limit the pro-cyclical effects of Basel II implementation in the United Kingdom.69 All of these reforms are certainly welcome.

More difficult issues arise with regard to the creation of counter-cyclical capital buffers. Separate discretionary and formula driven systems are available using different metrics. These can either work through increasing minimum ratios, such as on core tier one from four percent to seven percent or as a deduction from capital.70 The Turner Review argues that increasing capital in economic upturns (which would subsequently be available during a downturn) would decrease the probability of bank default, reduce system-wide bank failure, and avoid any amplification of the economic cycle.71 A figure of two to three

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65. Id.
66. Id.
67. Id.
68. Turner Review, supra note 2, at 59.
69. Id.
70. Id. at 62.
71. Id.
percent of weighted risk assets is suggested in the Discussion Paper as a possible benefit figure.\footnote{72} The same effects may nevertheless be achieved considerably more simply by increasing core tier one capital with banks already adopting a "through-the-cycle" approach to loss provision. Supervisory authorities already have considerable discretion in negotiating adequate reserve levels, both in terms of capital and liquidity with financial institutions, which could be adjusted across the cycle without any formal rule amendment or specific mechanical measures. In the event of any doubt or residual uncertainty, the market distortional effects of this new charge should mitigate against, rather than in favor of, its adoption. Existing national systems, such as that adopted in Spain are also more specific and particular than suggested in the Turner Review. Any revision in this area should be postponed until clear, commonly agreed, and tested measures have been produced that also satisfy any final cost benefit analysis.

\section*{F. Gross Leverage Ratio}

The Turner Review supports the adoption of a maximum gross leverage ratio such as an asset-to-capital multiple (ACM) of 20:1, as used in Canada.\footnote{73} A 12.5\% leverage limit is also effectively imposed under the Basel banking book rules that approximately equates with a total non-adjusted figure of twenty percent.\footnote{74} A simple ratio will further not take into the account the specificities of individual types of banking and securities business, with the main abuses being in the securities and not commercial bank areas. A relatively low ratio may then interfere with specific institutions, while an unnecessary high ratio would have no effect in practice. The imposition of a specific ratio is arguably then unnecessary and inappropriate. The issue could be more simply dealt with through recommended guidelines that take into account the full range of different activities that may be involved in different institutions and more complex groups. The most appropriate figures in any particular case can then be discussed with supervisors and set on an individual institutional basis.

\section*{G. Wider Issues}

The Turner Review raises three additional wider "open questions" in connection with product regulation, counter-cyclical economic management, and irrational momentum effects.\footnote{75} The objective is to raise "debate on principles."\footnote{76} This task is considered to be particularly necessary in light of the limits of market efficiency and market rationality discussed elsewhere within the paper and the extent to which markets can be made more efficient, rational, and self-correcting through transparency, liquidity, and technical efficiency corrections alone. The discussion in this part of the paper is, nevertheless, less substantial and more confused, with no firm conclusions being drawn.

\footnote{72} Discussion Paper, supra note 48.\footnote{73} Turner Review, supra note 2, at 67–68.\footnote{74} Id.\footnote{75} Id. at ch. 3.\footnote{76} Id.

The Treasury released its response White Paper on Reforming Financial Markets on July 9, 2009.77 This was an important policy document in setting out the government’s thinking on regulatory reform following the crisis and subsequent discussions including specifically under the Turner Review. While the Bank of England had not been consulted separately, and the governor only being provided with a copy just before release, many of the key reform ideas previously highlighted by the Bank have been taken forward in the White Paper. The White Paper is generally based on strengthened regulation and bank resolution with enhanced systemic risk oversight to be carried out principally under a new Counsel for Financial Stability (CFS).78 The Paper also includes important sections on consumer protection, competition, and, predictably, E.U. and international cooperation.79 As with the Turner Review, large parts of the report simply restate initiatives being taken forward by other bodies with much, if not most, of the detailed content of the reform package being postponed for subsequent agreement or distillation.80 The document is nevertheless of importance in clarifying in a considerably more moderate and balanced manner the U.K. government’s opinion (rather than the regulator’s opinion) of the changes required in the new post-crisis environment.

A. Structure

As with many other official documents, the July White Paper provides its formulation of the causes of the crisis (Chapter 3) with a discussion of regulatory reforms being postponed until the beginning Chapter 4 (beginning on p. 47).81 This discussion follows the Treasury’s summary of the importance of financial markets to the U.K. economy (under the title ‘Global Financial Markets’ in Chapter 1) and a summary of the action already taken by the government in response to the crisis (Chapter 2).82 While the core reforms are summarized in terms of more effective regulation and supervision, systemic oversight, resolution (and confidence), and taxpayer interest, the chapter headings focus on regulation (Chapter 4), defining systemically systemic firms and managing systemic risk (Chapters 5 and 6), international and European co-operation (Chapter 7), consumer protection (Chapter 8), and competition (Chapter 9).83 It is interesting that this paper is entitled Reforming Financial Markets, rather than Reforming Banking Regulation or Reforming Banking Markets, which reflects the wider policy approach adopted by the Treasury and especially with the inclusion of consumer protection and market competition issues. The earlier Turner Review only referred to reforming the Global Banking System more specifically.

78. Id.
79. Id.
80. Id.
81. Id.
82. Id.
83. Id.
B. Markets and Crisis

The functions of markets are outlined, although this summary is somewhat unstructured and disjointed. This review is essentially based on the efficient allocation of funds, risk management, innovation support, wealth accumulation, transaction completion, as well as monetary and fiscal policy management effectiveness.\footnote{Id.} U.K. financial services employs over one million people, provides eight percent of G.D.P., and generates £38bn in trade surplus, with over £250bn having been provided in terms of corporation tax, income tax, and national insurance contributions over the last nine years.\footnote{Id.} While the City of London is the major financial center in Europe, other U.K. cities also have significant international reputations, including Edinburgh. The separate report by Sir Win Bischoff on \textit{U.K. International Financial Services—The Future} in May 2009, noted that the eight percent output figure is comparable to the United States and Europe, although significantly less than other service-based economies such as Singapore and Hong Kong, and substantially less than U.K. manufacturing output at fourteen percent.\footnote{Id.} The U.K. government’s regulatory policy has been designed to support economic growth and prosperity, including the creation of the single integrated regulatory system under the Financial Services Authority (FSA), Financial Services, and Markets Act 2000 (FSMA), and Single Market within the E.U.\footnote{Id.}

The causes of the crisis are summarized in terms of failures in market discipline, systemic oversight, as well as what may be referred to as “regulatory delay.” The origins of the crisis are separately summarized in terms of innovation and search for yield, product complexity and non-transparency, poor risk management (in failing to understand the exposures assumed), and distortive remuneration packages. All of these failures undermined market discipline and were aggravated by poor governance while regulators failed to appreciate the systemic threats created. The main causal factors behind the U.K. crisis were principally summarized in terms of leverage, wholesale funding, high-risk product streams, and poor acquisition decisions.

C. Institutional Revision

The government considered that the integrated regulatory model set up in the United Kingdom under the FSMA remained the most appropriate although it would formalize arrangements for institutional cooperation on financial stability and strengthen the governance arrangements, objectives, and powers of the FSA rather than include the FSA and Treasury within the new subcommittee on Financial Stability to be set up at the Bank of England under the Banking Act 2009.\footnote{Banking Act 2009, §§ 238-40.} The government had decided to establish a new Council for Financial Stability (CFS) under a statute that would replace the earlier Tripartite Standing Committee, but again consists of the Bank of England, the FSA, and the Treasury, with meetings chaired by the Chancellor of the Exchequer.\footnote{Id. § VI.} The objectives of the CFS would be to analyze and examine emerging risk to the financial stability of the
U.K. economy and coordinate the most appropriate response.\textsuperscript{90} The earlier informal Memorandum of Understanding (MoU) on Financial Stability entered into between the tripartite authorities in 1998, and then replaced in March 2006, was to be replaced by new Terms of Reference for the CFS.\textsuperscript{91}

The government had already extended the governance arrangements within the Bank of England under the Banking Act 2009.\textsuperscript{92} The government would confer on the FSA a parallel statutory financial stability objective, in addition to its core objectives of maintaining confidence, promoting understanding, consumer protection, and financial crime.\textsuperscript{93} Failing to impose a specific statutory objective concerning financial stability on the FSA always appeared to be a significant omission. This gap could only be explained in terms of the combined or collective nature of the role with the FSA having to work with the Bank of England and Treasury. The FSA had nevertheless interpreted its other four statutory objectives to include financial stability from an early stage. Any argument or claim that it failed to realize that it was required or expected to assume a more general systemic (full sector or macro-prudential), rather than solely individual firm (micro-prudential), role or function may be considered to be disingenuous.

The statutory objectives of the FSA were, in particular, to be extended following the White Paper to include an express duty to have regard to international and European developments and to consider wider economic and fiscal costs of failure in determining the most appropriate regulatory action to take.\textsuperscript{94} Further governance amendments would be considered following the FSA's own review of its board effectiveness.\textsuperscript{95} The FSA's rule-making powers under Section 138 FSMA would be extended to cover all of its revised statutory objectives, in addition to consumer protection.\textsuperscript{96} This authority would then include larger economic justifications and taxpayer interest, as well as financial stability, which is implied in consumer protection.

The Treasury White Paper contains further discussion on such matters as enhanced regulation and resolution, significantly systemic firms and systemic oversight, European and international co-operation, consumer protection, and competition, although much of these matters simply follow other regulatory initiatives that have been taken forward at the European or other international levels.\textsuperscript{97}

\textsuperscript{90} Id.

\textsuperscript{91} Id.

\textsuperscript{92} Banking Act 2009, §§ 238-40 (This included: (a) providing the Bank with a formal statutory financial stability objective; (b) setting up the Financial Stability Committee (FSC) within its Court including external membership; (c) replacing its earlier governance arrangements with a smaller more strategically focused Court of Directors; and (d) conferring new power and authority in connection with the administration of the Special Resolution Regime (SRR) set up for banks and building societies under the Banking Act 2009).


\textsuperscript{94} Blair, et al., supra note 58.

\textsuperscript{95} Id.

\textsuperscript{96} Id.

\textsuperscript{97} Id.
IV. Walker Review of Corporate Governance—July 2009

The former Executive Director of the Bank of England, Sir David Walker, had been asked by the U.K. Prime Minister Gordon Brown in February 2009, to examine corporate governance in the U.K. banking industry and make recommendations for its reform. The Review was issued on July 16, 2009 and followed separate reports by the Basel Committee on Banking Supervision and by the Organization for Economic Cooperation and Development (OECD) on governance matters. The Walker Review does not attempt to explain the crisis, although it notes that the fact that a number of institutions in almost identical circumstances performed with widely varying results must have meant an important factor was the manner in which they were managed.

Despite the massive dislocation and costs suffered, a correct balance had to be achieved in terms of innovation and regulation and between the interests of shareholders and society. An appropriate balance had also to be achieved between the roles of executive and non-executive board members and short and long-term company objectives. Sir David attributed good corporate governance to the ability and experience of the individuals concerned and the effectiveness of their collaboration with the principal recommendations attempting to reconcile the need for prescription, judgment, and flexibility. Sir David had worked closely with Sir Christopher Hogg, Chairman of the Financial Reporting Council (FRC), which was undertaking a parallel review of the U.K. Combined Code on Corporate Governance for all listed companies in the United Kingdom.

The Walker Review identifies five key themes. The FRC Combined Code was considered fit for purpose with Sir David specifically approving of its “comply or explain” approach to guidance and provisions applicable to banks and other financial institutions (referred to as BOFIs). The principal deficiencies in board conduct identified related more to patterns of behavior and operation rather than organization, with many boards failing to carry out the core “challenge step” within the decision-taking procedure (or sequence). There had to be higher degrees of board level engagement in the monitoring of risk and the risk process, including the institution’s risk appetite and tolerance. Fund managers and major shareholders had to engage more directly with firms to support long-term performance improvements with boards being receptive to this intervention.

98. WALKER REVIEW, supra note 4, at 5.
99. Id. at 1.
100. BASEL COMM. ON BANKING SUPERVISION, ENHANCING CORPORATE GOVERNANCE FOR BANKING ORGANISATIONS (2006) (the Basel Committee issued a revised set of guidance on the adoption of effective corporate governance practices within banks and banking groups. The purpose was to attempt to ensure the adoption and implementation of sound corporate governance practices within banks and banking groups across the world although this would not replace but support existing regulatory laws, rules, and codes. This revises the earlier guidance issued by the Committee in 1999. The paper also attempts to incorporate the principles for corporate governance issued by the OECD in 2004).
101. WALKER REVIEW, supra note 4.
102. Id. at 11.
103. Id.
104. Id. at 12.
105. Id.
106. Id.
There had to be substantial enhancement of board level oversight of remuneration policies, especially with regard to variable pay and associated disclosures.\textsuperscript{107}

The Review contains thirty-nine recommendations to be given effect through incorporation as guidance into the Combined Code provisions.\textsuperscript{108} The FRC would determine how these recommendations would apply with regard to non-financial entities also subject to the terms of the Combined Code, which applied to all listed companies.\textsuperscript{109} The recommendations were structured in terms of board size, composition and qualification, board function and evaluation of performance, institutional shareholder role, communication and engagement, risk governance, and remuneration.\textsuperscript{110}

The Walker Review was important in confirming the need for strong and effective corporate governance within banks and other financial institutions. This clearly goes beyond remuneration and concerns the key role and function of boards on financial institutions including their size, composition, qualification, function, and performance. Many of the more specific recommendations made may be considered to be predictable and more clarificatory in nature. Important confirmations are nevertheless made, for example, with regard to training, support, commitment, risk focus, communication, and evaluation. The governance of risk is also to be strengthened, especially with the establishment of a separate board risk committee and the appointment of a dedicated chief risk officer (CRO) with sufficient power and authority to act.\textsuperscript{111} The remuneration recommendations largely follow the new culture set out in the FSA Remuneration Code requirements and principles, although some important extensions are made in terms of “high end” package approval and disclosure, payment deferrals (of up to five years), conditions, “clawback,” as well as remuneration committee procedures and consultancy.\textsuperscript{112} To what extent major financial institutions would implement all of these proposals and the effect of the deferral, conditions, and performance obligations remains to be seen.

The more difficult and sensitive recommendations relate to attempting to reinforce the role of fund managers and other institutional shareholder groups. Professional managers and owners may resent the interference and question the need for this direct involvement. Many may argue that they are entitled to rely on the paid executive and non-executive management and various committees and sub-committees appointed to carry out effective governance within a company. Many are more concerned with managing total portfolio performance and acting in the interests of their specific clients rather than protecting the interests of the investee entity on a longer-term basis. This fundamental difference in approach and responsibility remains a difficult issue going forward.

\textsuperscript{107} Walker Review, supra note 4, at 12. Board remuneration committee functions had to be extended beyond board members to include remuneration throughout the firm with committees able to withstand pressure from shareholders or the executive where appropriate. Performance conditions and deferment of variable pay for executive board members and other senior executives had to be strengthened with deferrals being up to five years.

\textsuperscript{108} Id.

\textsuperscript{109} Id.

\textsuperscript{110} Id. at 14-21.

\textsuperscript{111} Id. at 13.

\textsuperscript{112} Id. at 115.
V. Bank Resolution and the Banking Act 2009

Further major reforms in connection with bank reconstruction and reconciliation were taken forward under the Banking Act 2009, which came into effect in February. The government had introduced to the House of Commons the Banking Bill 2008, on October 6, 2008 (Bill 147) following the consultation papers issued by the Treasury with the Bank of England and Financial Services Authority (FSA) on banking reform in October 2007, and January and July 2008. These reports were produced in response to the apparent weaknesses revealed in U.K. banking law concerning the management and resolution of banks facing financial difficulties. This review was considered necessary after the problems at Northern Rock, which was forced to seek emergency assistance from the Bank of England in September 2007, and was subsequently nationalized in February 2008, after private sector bids for the bank had been rejected by the Treasury. The Banking Act 2009 does not alter the structure of the system of integrated financial regulation set up under the FSMA, although it supplements it with the establishment of a new resolution regime for banks and other consequential amendments to the structure and operation of the Bank of England and the Financial Services Compensation Scheme (FSCS) which was set up under Part 15 FSMA.

The principal purpose of the Banking Act was to establish a new Special Resolution Regime (SRR) for failing banks. Transitional provisions had been introduced under the Banking (Special Provisions) Act in February 2008, to allow the Treasury to transfer the assets and liabilities of a bank to another institution where such action was considered necessary to maintain financial stability or protect the public interest. These provisions were nevertheless incomplete by themselves and were intended to lapse after one year. A more complete and coherent permanent SRR regime was then created under the Banking Act. The Treasury may extend the application of the SRR to building societies by order (under Section 130) as well as to credit unions with appropriate amendment (Section 131). The Treasury has consulted separately on the establishment of a parallel regime for investment banks (under Section 233).

The Banking Act contains three general procedures for dealing with failing banks. These consist of the new permanent Special Resolution Regime (SRR under Part 1), a dedicated Bank Insolvency Procedure (BIP under Part 2), and a revised Special Administration Regime (SAR or Bank Administration Procedure (BAP) under Part 3).

114. Walker, Credit Markets, Bretton Woods II and Global Response, supra note 1, at 79.
115. Id.
117. Banking (Special Provisions) Act, 2008, c.2 (Eng.).
118. Id.
120. HM TREASURY, DEVELOPING EFFECTIVE RESOLUTION ARRANGEMENTS FOR INVESTMENT BANKS (2009), available at http://www.hm-treasury.gov.uk/consult_investment_banks.htm. A new definition of investment bank is created under Section 232 of the Banking Act 2009. An "investment bank" means an institution which satisfies the following three conditions: (a) holds permission under the FSMA to carry on the regulated activity of safeguarding and administering investments, dealing in investments as principal, or dealing in investments as agent; (b) the institution holds client assets; and (c) is incorporated in, or formed under the law of any part of, the United Kingdom.
121. Banking Act 2009 § 1(i-v).
Banking Act amends the operation of the FSCS (Part 4), formalizes the role of the Bank of England in its oversight of U.K. payment systems (including payment systems embedded within securities transfer systems) (Part 5), and strengthens the nature of the system of note issuance by Scottish and Northern Irish banks in the event that an issuing bank may face financial difficulty (Part 6).122

A. Special Resolution Regime (SRR)

The SRR is established under Part I of the Banking Act. The purpose of the SRR is to deal with situations where all or part of the business of a bank has encountered, or is likely to encounter, financial difficulties.123 The SRR provides for three specific “stabilization options” with either a of transfer to a private sector purchaser (Section 1), transfer to a “bridge” bank following the U.S. model (Section 12), or transfer to temporary public ownership (Section 13).124 The three stabilization options may be achieved through the exercise of one or more of the “stabilization powers” which consist of “share transfer powers” and “property transfer powers” (Section 1(4)).125 The SRR is to be implemented by the Bank of England with the Treasury and FSA.126

B. Special Resolution Objectives

The Banking Act sets out five “special resolution objectives” (Section 4).127 These objectives consist of protecting and enhancing the stability of the “U.K. financial systems,” protecting and enhancing public confidence in the stability of the U.K. banking systems, protecting depositors, protecting public funds, and avoiding interfering with property rights in contravention of a Convention right under the Human Rights Act 1998.128

C. Code of Practice

The Treasury has issued a Code of Practice concerning the use of the stabilization powers and the bank insolvency and bank administration procedures.129 The code includes specific guidance on the achievement of the special resolution objectives, consultation information, provision of advice by one relevant authority to another, exercise conditions, reports, and notices.130

122. Id. § 1 (vi-vii).
123. Id. § 1(1).
124. Id. § 1(2).
125. Id. § 1(4).
127. Id. § 4.
128. Id.
130. Id.
D. Exercise of Powers

The FSA is to determine whether the general conditions for the exercise of a stabilization power have been complied with (Section 7(1)).\(^{131}\) The relevant bank must be failing or likely to fail in order to satisfy the threshold conditions imposed under FSMA Section 41(2) FSMA (Condition 1 under Section 7(2)),\(^{132}\) or it is not reasonably likely that action will be taken to allow the bank to satisfy the threshold conditions apart from any stabilization powers (Condition 2 under Section 7(3)).\(^{133}\)

The Bank of England may then trigger a private sector purchase or bridge bank transfer where one of two further conditions has been satisfied. The power must be necessary in the public interest with regard to the stability of the U.K. financial systems, maintaining confidence in the stability of the U.K. banking systems or the protection of depositors (Condition A under Section 8(2)(a), (b) and (c)),\(^{134}\) or the Treasury has provided financial assistance to a bank, has recommended the exercise of the stabilization power to protect the public interest, and the exercise of the power is considered appropriate by the Bank of England (Condition B under Section 8(5)(a) and (b)).\(^{135}\)

The Treasury may only take a bank into temporary public ownership (under Sections 9(1) and 13(2))\(^{136}\) where the exercise is necessary to resolve or reduce a serious threat to the stability of the U.K. financial systems (Condition A under Section 9(2))\(^{137}\) or to protect the public interest after the Treasury has provided financial assistance to the bank (Condition B under Section 9(3)).\(^{138}\)

E. Partial Transfers

Restrictions may be placed on the making of partial transfers of some, but not all, of the property, rights, and liabilities of a bank under the property transfer powers. By order, the Treasury may impose restrictions by reference to the nature of the property, rights, and liabilities forming part of the transfer (Section 47).\(^{139}\) Private law rights are to be protected under Section 48.\(^{140}\) This restriction will apply to any interests that may be specified including security interests, title transfer collateral arrangements, set-off, netting arrangements, and other protective arrangements.\(^{141}\) Authorities may require “residual banks” and “other group companies” to provide services and facilities (continuity obligations) following a partial transfer of business.\(^{142}\) The powers are again exercisable by the Treasury by order. Partial transfers may apply with regard to transfers of the deposit book

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132. Id. § 7(2).
133. Id. § 7(3).
134. Id. § 8(2)(a-c).
135. Id. § 8(5)(a-b).
137. Id. § 9(2).
138. Id. § 9(3).
139. Id. § 47.
140. Id. § 48.
only, facilitating pre-agreed private sector transfers, or cleaning up the bank's balance sheet to remove distressed assets.\textsuperscript{143} The revised provisions prohibit the transfer of some, but not all netting contracts with express carve outs for specific transactions, including non-transferrable foreign law contracts and claims.\textsuperscript{144} Counterparty credit risk and bank regulatory capital compliance are principally secured through netting arrangements. It is essential that full legal certainty be secured in this regard. Liabilities should be transferred with associated collateral to ensure effective enforcement. The integrity of structured finance transactions is also to be protected subject to final arrangements.

\section*{F. INCIDENTAL AND AMENDMENT POWERS}

Incidental functions are specified in Sections 63-75.\textsuperscript{145} These include express provisions concerning continuity, pensions, enforcement disputes, and tax.\textsuperscript{146} One of the most controversial provisions in the original bill was the conferral of power on the Treasury to amend the law by order "for the purpose of enabling the powers under this Part to be used effectively, having regard to the special resolution objectives."\textsuperscript{147} This provision was referred to as the Henry VIII clause with its power of retroactive legal amendment. The original Clause 65 was amended not to allow the Treasury to amend the Banking Act itself or protections provided by the Banking Act, although the British Bankers' Association had called for this restriction to be qualified further.\textsuperscript{148} The legal amendment power in Section 75 may be used for general or specific purposes and be subject to either the draft affirmative procedure or the twenty-eight day affirmative procedure within Parliament in urgent cases.\textsuperscript{149} This power was questioned by the House of Lords\textsuperscript{150} and examined by the Constitutional Committee of the House of Lords separately.\textsuperscript{151} The Committee had accepted the general need for the provision although it was not persuaded that the scope sought was justified and welcomed the government's indication that it would consider introducing a more limited and targeted retrospective power. The Treasury may also issue regulations in connection with the tax consequences of implementing the stabilization powers with a further retrospective effect (Henry VIII power) being included in Section 74(5).\textsuperscript{152}

\begin{footnotesize}
\begin{enumerate}
\item Id. § 47.
\item Id. § 39.
\item Id. §§ 63-75.
\item Id.
\item Id. § 75.
\item Banking Act 2009, § 72.
\item Id. § 75.
\item Banking Act 2009, § 72.
\item The Select Committee on the Constitution within the House of Lords considered the effect of clause 75 separately which allowed the Executive to unapply or modify existing laws with retrospective effect. The Committee noted that there was not an absolute prohibition on Parliament giving the Executive power, by order, to repeal, unapply or otherwise amend Acts of Parliament, delegated legislation or the common law although constitutional principles required that (a) any such power should only be granted on compelling justification, (b) the scope should be limited to the minimum necessary and (c) any order should generally be subject to Parliamentary control (under negative or affirmative resolution).
\item Banking Act 2009, § 74(3).
\end{enumerate}
\end{footnotesize}
G. Financial Stability Objective

The Banking Act also amended Section 2 of the Bank of England Act 1998 to include an express financial stability objective for the Bank of England. Section 2A of the Bank of England Act 1998 is “to specify that an objective of the Bank shall be to contribute to protecting and enhancing the stability of the financial systems” of the United Kingdom. In so doing, the Bank is to work with other relevant bodies (including the Treasury and FSA) with its Court of Directors determining and reviewing the Bank’s strategy in relation to its financial stability objective in consultation with the Treasury. No further guidance was provided in the Explanatory Notes on the Bank’s objective of contributing to the protection and enhancement of financial stability in the United Kingdom.

The court is required to create a separate Financial Stability Committee to make recommendations concerning the nature and implementation of the bank's strategy concerning its financial stability objective, provide advice on the action to be taken in connection with a specific institution or the exercise of the Bank's stabilization powers, exercise of the Bank's functions in connection with inter-bank payment systems, and any other delegated functions. The Financial Stability Committee is to consist of the Bank's Governor, Deputy Governors of the Bank, and four other directors of the Bank appointed by the Chair of the Court. The number of members of the Court is also reduced from sixteen to nine, but with meetings being reduced from monthly to seven times a year. The Turner Review had argued that the FSA should be a member of the new committee, although this occurred before it was announced that the government would set up the separate Council for Financial Stability (CFS) with the FSA now sitting with the Bank and Treasury on the new Counsel for Financial Stability (CFS).

VI. Financial Services Act

The government brought forward a further Financial Services Bill on November 19, 2009. This was enacted on April 8, 2010, although a number of key provisions had to be dropped by the government to allow passage before the general election in the United Kingdom on May 6, 2010. The Act is generally designed to improve the oversight of system-wide risks, deliver more effective regulation and supervision, ensure that remuneration policies are transparent and appropriate, provide additional protection to consumers,
and correct certain other perceived failures in the current regulatory system within the United Kingdom. The Act supports the regulatory framework set up under the Financial Services and Markets Act 2000 (FSMA), although it reforms and extends this in a number of respects. The government had separately brought into effect the Banking Act 2009 referred to above to allow for the effective resolutions of banks in distress. A number of the measures contained in the Act were provided for in the Treasury’s paper on Reforming Financial Markets in July 2009. As noted, the July 2009 paper was based on stronger market discipline, better regulation, managing failure, and better market infrastructure.

The original Bill contained ten principal proposals for regulatory reform. A new Council for Financial Stability (CFS) was to be established to replace the earlier Tripartite Standing Committee made up of the Chancellor of the Exchequer, Governor of the Bank of England, and Chairman of the FSA. The FSA is given an express financial stability statutory objective with its earlier objective of promoting public understanding of the financial system being removed and responsibility for financial capability transferred to a new consumer financial education body. The new agency will take over responsibility of the FSA functions in connection with the National Strategy for Financial Capability.

The FSA is to make general rules requiring firms to maintain remuneration policies with the Treasury being able to issue regulations concerning the preparation, approval, and disclosure of executives’ remuneration reports. The FSA is to issue separate rules concerning the preparation of recovery and resolution plans (RRPs). The FSA is given new power to prohibit or require the disclosure of short selling practices. Greater enforcement powers are conferred on the FSA with explicit authority to suspend or limit unauthorized person’s permission or an approved person’s approval.

A significant new power to bring forward collective proceedings was provided in respect of financial services claims before these provisions were dropped from the final Act. Collective proceedings were to be brought by a representative on behalf of a group with the same or connected claims who would be entitled to proceed individually. The representative was not required to have a direct interest in the proceedings. The FSA may still issue rules requiring firms to establish consumer redress schemes where there has been a widespread or regular failure by a firm to comply with its regulatory obligations. Credit card cheques may not be sent on an unsolicited basis.

166. Id.
167. Id. § 6.
168. Id. § 7.
169. Id. § 8.
170. Id.
171. Id.
172. Id. § 14.
173. Id. § 15.
The Financial Services Compensation Scheme (FSCS) is required to contribute to the expenses incurred in the exercise of stabilization powers under the Banking Act 2009.\textsuperscript{174} This will take into the account the costs that the scheme would have incurred in funding compensation payments if the stabilization power had not been exercised and payments may be made on behalf of other compensation schemes. The FSA is to be given a new power to obtain information relevant to financial stability with the Treasury being able to require information or documents from participants in the Asset Protection Scheme (APS) or similar schemes.\textsuperscript{175} Additional provisions with regard to the new consumer financial education body are set out in Schedule 1 with the Scottish Parliament to be consulted where the new entity affects devolved powers under the Sewel Convention.\textsuperscript{176} Further minor and technical amendments are made to the Banking Act 2009.

This is an important new legislative measure and much of the Act operates by way of amendment to other existing statutes including, in particular, the FSMA 2000 and Banking Act 2009 although it does contain certain standalone provisions especially with regard to the establishment of the Council for Financial Stability (CFS) and operation of the consumer financial education body. The Act is generally concerned with financial stability, financial capability, remuneration, recovery and resolution, collective action and redress, and strengthening of other enforcement and recovery schemes.

A. Financial Stability

The November Bill provided for the establishment of the Council for Financial Stability (CFS) consisting of the Chancellor, the Chair of the FSA, and Governor of the Bank of England with the Chancellor as Chair.\textsuperscript{177} The CFS was anticipated in the July 2009 Treasury paper on Reforming Financial Markets but had to be deleted from the final Act.\textsuperscript{178} The Conservatives had objected to the new CFS with its future title and role then being dependent upon which party won the general election on May 6, 2010. The duties and functions of the CFS were not specified in the Bill but referred to in the White Paper. The CFS is to keep under review matters affecting the stability of the U.K. financial system and to coordinate any action taken (or to be taken) by the relevant authorities for the purpose of protecting or enhancing the stability of the system.\textsuperscript{179} The Treasury was given power to issue a statement on the exercise of the CFS’s functions.

The Treasury had earlier issued draft Terms of Reference.\textsuperscript{180} This restates the CFS’s functions and the Treasury’s power to issue terms. The functions of the Bank, FSA, and Treasury are confirmed following those set out in the revised Memorandum of Understanding (MOU) between the tripartite authorities issued in 2006.\textsuperscript{181} The CFS is responsible for considering emerging risks to the financial stability of the U.K. and global

\begin{itemize}
\item Id. § 16.
\item Id.
\item Legislative Consent Memorandum, Financial Services Bill (2009) (Scot.), available at http://www.scotland.gov.uk/About/Sewel/SessionThree/FinancialServicesBill.
\item Reforming Financial Markets, supra note 3.
\item Id. at ch. 4.
\item Id.
\item Id. at ¶ 21.
\end{itemize}
financial system and coordinating an appropriate response by the relevant U.K. authorities.\textsuperscript{182} It is only a monitoring and coordinating body. In pursuing its core objective of monitoring stability, it will have regard to strategic medium to long-term developments affecting financial stability and more immediate issues.\textsuperscript{183} The CFS is to meet as necessary to coordinate the authority’s response in managing any financial or operational crisis.\textsuperscript{184} The Financial Stability Sub-Committee (FSC) will draw on external expertise as necessary through invited expert participation including members of the Court of the Bank or FSA boards.\textsuperscript{185} The Tripartite MOU is to be further revised to work with the terms of reference for the FSC.\textsuperscript{186}

The CFS is to meet at least four times a year or as otherwise necessary with other timing, attendance, agenda, and minute matters being dealt with in the original Annex A.\textsuperscript{187} Separate meetings of the CFS Deputies are to be held monthly under Annex B.\textsuperscript{188} This follows the earlier practice of the Tripartite and Tripartite Deputy meetings.

The statutory objectives of the FSA under the FSMA are amended under the final Act by including a new financial stability objective (in Section 2(2)(ab) FSMA) and with its existing public awareness objective in section 2(2)(b) FSMA being deleted.\textsuperscript{189} The financial stability objective is stated to be to contribute to the protection and enhancement of the stability of the U.K. financial system.\textsuperscript{190} The FSA is to consult with the Treasury on determining and reviewing its strategy in relation to the financial stability objective.\textsuperscript{191}

B. Financial Capability

With the repeal of the FSA’s public awareness objective, responsibility for financial stability is to be transferred to a new consumer financial education body (CFEB) to be set up by the FSA under a new Section 6A FSMA.\textsuperscript{192} This parallels the Consumer Financial Protection Agency (CFPA) to be set up in the United States.\textsuperscript{193} The function of the agency is to enhance understanding and knowledge of members of the public on financial matters and the public’s ability to manage its own affairs.\textsuperscript{194} The types of money guidance, service, and programs to be provided by the CFEB are set out in Section 6A(2).\textsuperscript{195}

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{182}] Id. at ¶ 17.
\item[\textsuperscript{183}] Id. at ¶ 16.
\item[\textsuperscript{184}] Id. at ¶ 19.
\item[\textsuperscript{185}] Id. at ¶ 20.
\item[\textsuperscript{186}] COUNCIL FOR FIN. STABILITY, DRAFT TERMS OF REFERENCE, supra note 180, at ¶ 21.
\item[\textsuperscript{187}] Id. at Annex A.
\item[\textsuperscript{188}] Id. at Annex B.
\item[\textsuperscript{189}] Id. at ¶ 1. See also Financial Services Act 2010 § 2.
\item[\textsuperscript{190}] COUNCIL FOR FIN. STABILITY, DRAFT TERMS OF REFERENCE, supra note 180, at ¶ 1. The FSA is to have regard to: (a) the economic and fiscal consequences for the U.K. of instability of the U.K. financial system; (b) the effects (if any) on the growth of the economy of the U.K. or of anything done for the purpose of meeting that objective; and (c) the impacts (if any) on the stability of the U.K. financial system of events or circumstances outside the U.K.
\item[\textsuperscript{191}] COUNCIL FOR FIN. STABILITY, DRAFT TERMS OF REFERENCE, supra note 180, at ¶ 1.
\item[\textsuperscript{194}] Financial Services Act 2010 § 2 (inserting new § 6A(1)(a) FSMA 2000).
\item[\textsuperscript{195}] The consumer financial education function includes: (a) promoting awareness of the benefits of financial planning; (b) promoting awareness of the financial advantages and disadvantages of the supply of particular goods or services; (c) promoting awareness of the benefits and risks associated with different types of
\end{itemize}
\end{footnotesize}
While a new consumer financial education body is to be established, this is to be set up and managed under the direction of the FSA. The FSA will appoint the Chair, Chief Executive, and Board of the new CFEB. The FSA will approve the CFEB’s annual budget and annual plan. It will issue rules for the collection of fees from FSA regulated firms to cover its establishment and running costs. Levies will also be charged from Office of Fair Trading (OFT) licensed firms.

The FSA is to be closely involved, although this is an interesting although arguably unnecessary initiative. The FSA had developed a worldwide reputation for the lead it had taken in the consumer education and financial capability area. Setting up a new body may only dilute the effectiveness of the work already carried out by the FSA with the new agency not being able to deliver comparable successes in future.

C. EXECUTIVE REMUNERATION

The Act gives the Treasury power to issue regulations concerning the preparation, approval, and disclosure of executives’ remuneration reports, with the FSA required to issue rules requiring every authorized person to operate in accordance with a set remuneration policy. The Treasury regulations will require the production of reports disclosing information on the remuneration amounts paid to officers and employees of authorized persons under the FSMA. This disclosure supplements the information already provided in Directors’ Remuneration Reports for Quoted Companies. The provisions effectively only extend the existing powers to include non-quoted companies and non-board employees.

The FSA is to issue general rules concerning the production and compliance with internal remuneration policies. These apply to the payment of benefits to officers, employees and other persons of a specified description. Remuneration policies must be consistent with the effective management of risks and the Implementation Standards issued by the Financial Stability Board (FSB) in September 2009. The FSA may require remuneration policies to be revised. The FSA may also prohibit persons or specified persons from being remunerated in specified ways, declare any contrary provisions void, and financial dealing; (d) publication of educational material of the carrying on of educational activity; and (e) the provision of information and advice to members of the public. Financial Services Act 2010, § 2 and new §6A(2) FSMA 2000.

197. Id. at Schedule 1.
198. Id.
199. Id.
200. Id.
201. Id. ¶ 4(1).
202. Id. ¶ 4(2).
203. Id. Regulations on directors’ remuneration reports are provided for under Section 421 of the Companies Act 2008 and Schedule 8 to the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI2008/410). This includes disclosure of comparative information including the ratio between the highest and lowest paid members of staff.
204. Id. ¶ 6 (inserting new § 139A FSMA 2000).
205. Id.
206. Id.
permit recovery of any payments made under an avoided provision. These measures fall far short of the power to "rip up" bonus packages referred to in the press.

Remuneration practices can be improved, although this will take time especially with the contractual obstacles already in place. A number of measures have already been adopted by many of the major financial groups. Many of the recommendations issued by the FSA in its Code of Practice and the FSB and other bodies simply reflect market practice.

Particularly sensitive issues arise with regard to institutions receiving central bank or government support. Reasonable and proportionate bonus payments must nevertheless be continued to be made to retain quality staff. Boards and remuneration committees must be given a certain degree of judgment in determining what payments are appropriate and those that are excessive in particular circumstances. Such matters will be discussed with government shareholding agencies involved including, for example, the U.K. Financial Investment. A blanket ban on bonus payments cannot be supported on an economic, competition, or legal basis.

D. RESOLUTION AND RECOVERY

The FSA is to be required to make general rules concerning the preparation of recovery and resolution plans (Living Wills) by authorized persons. The Bill contains provision for the issuance of separate recovery and resolution plans with recovery dealing with continuity planning and resolution with business failure. The purpose of a recovery plan is to reduce the likelihood of failure by specifying the action that would be taken in the event of stress circumstances arising that would affect the ability of the firm to carry on all or part of its business. This may include restructuring, downsizing, or disposal. Resolution plans are to specify the action to be taken when a firm is likely to fail or in the event of failure.

These are important initiatives, which reflect other international proposals for the establishment of living wills by financial institutions. It is interesting that the U.K. legislation provides for the preparation of separate recovery (rehabilitation) and resolution (failure) scenarios. It may be more effective to deal with these together, especially as resolution will include post-event but pre-closure trading difficulty during which recovery plans would also apply. It may be that integrated recovery and resolution plans (RRPs) will be prepared in practice. Further guidance will be issued by the FSA in due course on the content of such RRPs. This single clause (which inserts five new connected sections within the FSMA) was possibly one of the more important provisions of the Bill.

The FSA is given a separate power (rather than obligation) to issue rules concerning the prohibition of short selling in particular circumstances. Short selling is a legitimate trading practice that assists determining the most accurate price for shares and can promote market liquidity. Short selling can nevertheless be used to drive the price of shares

207. Id.
208. Id. § 7 (inserting new § 139B FSMA 2000).
209. Id. § 7.
210. Id. § 7. This will include assisting authorities and insolvency officials manage a firm's winding-up including the establishment of 'data rooms' to collect and distribute information effectively.
211. Id. § 8 (inserting new § 131B FSMA 2000).
in financial institutions down with the short sellers profiting from the forced price collapse. This may then be considered to amount to a form of market abuse or market manipulation.\textsuperscript{212} It may also increase market instability by undermining confidence in financial institution stock. This creates a form of investment "run" parallel to a bank run. Many short sellers were considered to have contributed to share price collapse during the financial crisis of such institutions as HBOS and then RBS in the United Kingdom and Lehman Brothers and other major Wall Street investment houses, Merrill Lynch, Morgan Stanley, and Goldman Sachs. Temporary bans were introduced in the United Kingdom and United States following share price collapses although not until after the acquisition of HBOS by Lloyds.\textsuperscript{213}

E. COLLECTIVE ACTION AND CONSUMER REDRESS

The original Bill attempted to strengthen collection action procedures in the United Kingdom, although these also had to be dropped from the final Act. This would have applied where large groups of consumers suffered loss following the conduct of specific regulated firms or groups of firms.\textsuperscript{214} The Treasury July 2009 paper refers to such instances as the miss-selling of endowment policies, personal pensions, split capital investment trusts, precipice bonds, and payment protection insurance.\textsuperscript{215} Procedures already exist for taking forward generic claims on a collective basis including through group litigation orders under Civil Procedure Rules. A number of difficulties nevertheless arise which have been highlighted by the Civil Justice Council (CJC).\textsuperscript{216} The European Commission has also issued a consultation paper on collection action.\textsuperscript{217}

The Bill would have given the court power to authorize collective proceedings to be brought by a representative in respect of a group of financial services claims.\textsuperscript{218} The representative is not required to have any direct interest in the claim.\textsuperscript{219} Collective proceedings mean proceedings brought by the representative on behalf of persons entitled to bring or who have already commenced specific proceedings in respect of the claim.\textsuperscript{220} The court will issue a collective proceedings order. Proceedings either will be on an opt-in or opt-out basis. The court will determine whether its judgment or order will bind representative persons and which representative persons.\textsuperscript{221}

The 2010 Act does contain an additional provision with regard to consumer redress schemes. Firms may be required by the FSA to conduct a review of past business activities and pay compensation to consumers under Section 404 FSMA.\textsuperscript{222} Revised provisions in-

\textsuperscript{212} Id.
\textsuperscript{214} Financial Services Bill 2009 ¶ 18-25.
\textsuperscript{215} Reforming Financial Markets, supra note 3, at ¶ 8.62.
\textsuperscript{218} Financial Services Bill 2009 ¶ 18.
\textsuperscript{219} Id.
\textsuperscript{220} Id.
\textsuperscript{221} Id.
\textsuperscript{222} Financial Services Act 2010 ¶ 14.
clude replacing the existing section 404 and inserting new sections 404a-g. The FSA may make consumer redress rules where there has been widespread or regular failure to comply with the relevant requirements, legally recoverable consumer loss, and it is desirable to secure redress in the particular case.

F. DISCIPLINE AND INFORMATION

FSA enforcement powers are strengthened. The FSA may suspend, limit, or otherwise restrict unauthorized person's permission for up to twelve months under a new Section 206a FSMA. This applies to breaches of any provision applied under the FSMA or a directly applicable E.U. regulation. The FSA may impose a penalty and withdraw authorization in respect of the same breach with the withdrawal of the earlier restriction contained in Section 206(2) FSMA. The FSA may impose a financial penalty on a person where the person has carried out a controlled function without approval unless they did not know or could not reasonably have been expected to have known that they were acting without approval. There was previously no sanction for this. The FSA may also suspend an approved person from carrying on certain functions or impose restrictions on those functions for up to two years.

FSA is provided with new powers to collect specified information relating to financial stability issues. The Treasury may also require the Financial Services Compensation Scheme (FSCS) to contribute to the costs of stabilization powers under a special resolution regime. This will be limited to the amount of compensation that the FSCS would otherwise have had to pay to depositors if the bank had become insolvent, less recoveries. Interest costs may be included within the calculation of expenses.

VII. U.K. Policy Comment

A number of provisional observations may be made with regard to the evolving U.K. regulatory policy and reform during the crisis and in the post-crisis period.

A. NORTHERN ROCK

The early phase of the U.K. crisis was dominated by the ad hoc attempts to rescue Northern Rock by essentially uncoordinated and untested Tripartite group arrangements. The Bank of England appeared to be hesitant and confused following the leak by the BBC that Northern Rock required emergency funding. Whether the Bank received incorrect legal advice on the legality of providing support under E.U. and U.K. law, it had cer-
tainly failed to ensure that it had all of the necessary powers to act in the event of a major crisis arising. Public and private institutions must ensure that they have clear mandates and the organizational and personnel resources, as well as proper legal powers to discharge them. Where powers are limited or deficient, this deficiency must be corrected before, and not after, a major crisis arises.

B. Tripartite System

Difficulties also appeared to have arisen with regard to the effectiveness of the inter-authority cooperation arrangements set up under Tripartite MOU. These difficulties may nevertheless have been attributed to the conflicting advice received or to the personalities involved rather than the nature of the mechanism itself. Despite earlier assurances that the Tripartite arrangements would be maintained, the government had decided by summer 2009 to replace the earlier informal Tripartite Standing Committee and MOU with a statutory-based Council for Financial Stability (CFS) and formal terms of agreement and engagement. This decision may have been made more for political rather than regulatory reasons, as the specific legal status of the new cooperation mechanism may be largely irrelevant in practice. Of more importance will be ensuring that it has a clear mandate and proper operational procedures and powers with all of the necessary staff and resources to carry out its functions. The government may have felt compelled to create a formal Council with the parallel initiatives being taken forward with the establishment of a Financial Services Oversight Council (FSOC) in the United States and the European Systemic Risk Board (ESRB) in the E.U. The fate of the proposed new U.K. CFS will now depend upon the outcome of the general election.

C. Early Policy Formulation

The initial policy statements issued by the Tripartite authorities in October 2007, January, July, and September 2008, were only loosely formulated and insubstantial in terms of regulatory and supervisory reform. The original objectives of confidence, transparency, critical banking functions, competition, and taxpayer interest were later reformulated as strengthening stability and resilience, reducing the occurrence of failure and impact of failure, effective depositor compensation, and strengthened coordination between the relevant authorities. A more valuable listing of necessary reforms was attached to the July 2008 paper on Financial Stability and Depositor Protection, which also anticipated the creation of the FSC within the Bank of England. A number of useful papers were also published by the House of Commons, Treasury Committee, and subsequently by two House of Lords Committees on various matters including Northern Rock, bank supervi-

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233. Id. at 571-72.
sion and regulatory reform, Icelandic banks and U.K. depositor protection, remuneration practice, European institutional arrangements, and most recently “too big to fail.” These papers provided important factual background on many aspects of crisis and assisted confirmation of policy directions, although their contribution in terms of substantive reform was more limited.

D. BANK RESOLUTION

The most significant early success was made in designing and bringing into effect the new Special Resolution Regime (SRR), initially under the Banking (Special Provisions) Act 2008 and then the Banking Act 2009 on a permanent basis. This regime created a comprehensive set of resolution mechanisms in the event of a major banking or other depository institution facing crisis. SRR options now include a private sector purchase, temporary private transfer (bridge bank on a U.S. model) or public ownership (nationalization) with revised bank administration (BAP), and bank insolvency procedures (BIP). A series of additional protections then had to be brought into effect with the retroactive amendment ("Henry VII"), transfer without restriction, transferee continuity, contractual displacement (or default disregard), group continuity, and pensions and tax adjustment clauses. These protections were intended to facilitate any restructuring, especially at short notice and possibly within a limited geographic area, although these substantially interfere with private property and contractual rights.

Legal protections for contractual netting, set-off, collateral, and other measures had to be brought into effect under the Safeguards instruments, which effectively reverses the presumption of proper private contractual enforcement and validity. These measures can be defended based on financial stability, the need to reinforce market discipline, and reduce moral hazard. They may nevertheless still constitute substantial interferences with private contractual rights and remedies and are contrary to the open liberal market culture of the City of London and the common law legal system. To what extent they may undermine continuing investment in bank stock and private bank capital remains to be seen. This protection may also have the unintended effect of requiring the government to hold on to its interests in LBG and RBS for considerably longer than intended.

E. TURNER REVIEW

The intellectual content of the U.K. policy debate was re-set with the publication of the Turner Review in March 2009, and later speeches by Lord Turner and other senior FSA officials. The review confirmed the need for the adoption of a systemic approach to bank regulation, a cyclic understanding of economic functions, strengthened capital and liquidity reserves, European branch passport review, and a new approach to macro-prudential...
supervision.242 The Treasury White Paper of July 2009 largely endorses the principal regulatory and supervisory recommendations made by Turner with much of this approach being dependent on separate agreement being achieved elsewhere at the E.U. and international technical committee levels.243 Many of the post-crisis reform papers issued operate on this “regulatory delegation” basis with only limited substantial reform being taken forward immediately.

Wider issues were also raised in the Turner Review with regard to possible product regulation, counter-cyclical capital tools, and credit supply; although no firm conclusions were fortunately drawn in these areas, which will allow further reflection and debate on these more controversial issues.244 The Treasury White Paper is also of value in clarifying that consumer protection and competition law issues arise, although it conveniently ignores the damage that aggressive competition can create in reducing regulatory standards, such as where new market entrants (such as Northern Rock) with lower cost burdens compete with more established operators by offering high loan to value (LTV) self-certification and mortgages, or other “teaser” products (below) and effectively drive down regulatory and market standards.245 These issues will be considered by the new Consumer Financial Protection Agency (CFPA) in the United States and by the FSA or new consumer financial education body (CFEB) in the United Kingdom.

F. CAPITAL AND LIQUIDITY

The need to strengthen capital cannot be refuted, although Lord Turner’s statement, in his review, that consensus already exists on the need for counter-cyclical capital charging overstates the argument. Counter-cyclical charging is complex, costly, possibly contradictory, difficult to apply (especially in identifying switching or reversal of asset price movements in the economic cycle), and possibly simply confused (with no segregation of assigned capital to act as a buffer during the downturn).

Capital adequacy can be strengthened far more simply and cost effectively by raising core tier one levels under existing powers of national regulatory discretion. This capital can then be supported by the use of other convertible capital items either within tier one (including preferred stock) or tier two (with equity convertible debentures or subordinated debt). It is understood that complex counter-cyclical capital charging would only raise capital levels by up to two or three percent, while this could be achieved much more easily and efficiently by simply raising the core tier one levels across the cycle. The continued references to higher buffers to cover miscreant losses in the event of an unidentified and undefined down turn in the cycle are also almost meaningless without some segregation, which is not provided for under current models. The Spanish model, which is often referred to, is principally concerned with loss provisioning rather than capital directly.246

244. Turner Review, supra note 2.
The FSA's Supervisory Enhancement Program (SEP) is to be fully supported following Northern Rock as well as its core proposals on strengthening liquidity oversight. Care must nevertheless be exercised to ensure that disproportionate costs are not simply imposed on banks or U.K. based banks placed at any significant competitive disadvantage with all of the additional information being reported never being properly used by the authorities. This would only increase regulatory cost at the expense of financial services customers with no direct or appreciable regulatory benefit.

G. GOVERNANCE

The principal recommendations of the Walker Review of Corporate Governance are also to be welcomed, especially with regard to board composition and qualifications, enhanced non-executive director role, risk oversight and performance evaluation, governance, and remuneration. The most useful proposals relate to creating a new culture of risk oversight at the highest level within banks and the promotion of executive challenge with strengthened NED and NEDCo functions. To what extent fund managers and other professional or institutional investors will subscribe to the separate recommendations made with regard to their assumption of a more direct disciplinary role, including publication of their commitment and policies in this regard, nevertheless remains to be seen. This specific set of proposals may only amount to regulatory "wishful thinking" in practice.

The decision to leave remuneration decisions to bank boards and market practice is to be fully supported. The FSA has already confirmed its general requirement that all firms must maintain policies that support effective risk management with the ten principles set out in its final Remuneration Code of Practice issued on August 12, 2009. This requirement is now further strengthened with the additional recommendations set out in the Walker Review with regard to oversight, high-end remuneration, deferrals, performance conditions, and possible clawback. Concerns may only arise with regard to the Walker five-year deferral period, which may be considered too long by some groups and have to be shortened in particular cases (to around three years). Package composition requirements including options and disposals are all already dealt with within the FSA guidelines.

The residual issue is then with regard to providing clear board guidance on actual package terms and conditions. The Walker Review contained no empirical data on the extent

248. WALKER REVIEW, supra note 4.
249. Id. at 28.
250. FIN. SERVICES Auth., FINAL REMUNERATION CODE OF PRACTICE (2009) (The final Code measures dilute earlier recommendations such as two thirds of each bonus should be deferred and that individual rewards should into account the overall performance of a firm rather than that of the individual or division alone. It was reported that the U.K. FSA was frustrated that there was less consensus than had been hoped with other agencies.). See also Brooke Masters and Patrick Jenkins, FSA Steps Back from PAY Rules for Banks, FIN. TIMES, Aug. 11, 2009, at 1. The U.S. Financial Remuneration Bill has also been brought forward although this again leaves individual packages to be negotiated at bank level with the systemic implications of remuneration more generally being considered by the new Financial Services Oversight Council (FSOC).
251. WALKER REVIEW, supra note 4.
252. FINAL REMUNERATION CODE OF PRACTICE.
to which contractually agreed remuneration practices had significantly contributed to causing the crisis (which many commentators have simply assumed) and provided no assistance in determining how to assess specific package amounts. The confidentiality that surrounds the issue makes it even more difficult in practice. The U.K. Treasury Minister Lord Myners had called for transparency on recipients, although this still avoids the issue. 253 New guidance should be issued that provides remuneration boards with a number of payment options and ranges (including ratios or other calculation mechanisms) to allow them to negotiate with senior managers and traders in a meaningful and responsible manner and to avoid endless “Groupthink” and the constant ratcheting up of packages. 254 While profit percentages may continue to be used, ceilings should be considered tied to multiples of basic salary. Excess bonus pool amounts not distributed in any one year should be retained for subsequent years or simply used to support pension or health insurance provision across the institution as a whole. Former RBS CEO Sir Fred Goodwin’s package should have been examined and negotiated at the time when it was initially agreed by the board and then later by the government, and not subsequently in the press after it was contractually immune from revision.

H. Treasury White Paper

The Treasury White Paper separately restated the need for financial firms to re-establish a relationship of trust with their clients. 255 The paper confirms that a number of specific initiatives have been taken forward in the United Kingdom specifically following the crisis, as well as part of the larger financial capability program in connection with which the FSA had become a world leader. 256 Consumer education is one of the FSA’s core statutory objectives as set out in the FSMA. This initiative is also closely related to maintaining market confidence, which is the first of the FSA’s statutory regulatory objectives as set out in the FSMA. 257 This requirement extends to both retail and wholesale counterparties, with the FSA having already interpreted it to include financial stability, although it will also now have an additional express financial stability function under the Financial Services Act 2010. 258 Not including financial stability as a proper and legitimate, if not principal, statutory objective was one of the main mistakes that the drafters of the Financial Services Act 2010 made.

253. Gillian Tett, Fool’s Gold 135 (2009) (Jamie Dimon caused considerable surprise after he took over as CEO and President at JP Morgan Chase in 2004 when he required that the payment terms of the 300 senior managers were disclosed for the first time internally and introduced standard contracts without special side deals.).
254. New remuneration rules may include (a) specifying the basic purpose of remuneration packages (such as provide pay for basic service provided, incentivise hard work and reward significant contributions to the firm); (b) recalibrate all basic salaries; (c) sue multiples of salary for reward; (d) retain percentage payments but impose ceilings (such as up to ten times basic salary); (e) impose a ‘value added’ test to confirm contribution to rear special terms; (f) impose further ‘no risk’ test to confirm no increase in firm risk exposure; (g) maximum disclosure and transparency; (h) shareholder vote on payments on all discretionary or special packages (possibly with continued executive override but only on cause with further rights of unanimous veto); (i) separate risk assessment on overall firm payment packages as a whole; (j) regulatory report on packages and risk assessment; (k) right of regulatory response; (l) capital penalties if necessary; and (m) the provision of trade association recommended guidelines in all key sectors.
255. Final Remuneration Code of Practice, Cm. 7667.
256. Id.
257. Id.
made in preparing the original FSMA terms, which is otherwise generally regarded as being an excellent piece of regulatory drafting. The Financial Services Act also contains other important provisions with regard to financial stability, remuneration, recovery and resolution, and redress, and strengthening of other enforcement and recovery schemes but with regard to the proposed CFS and not on collective action.\textsuperscript{259}

I. Competition

The White Paper was separately useful in confirming the importance of competition and the need to maintain open and efficient markets, although it omitted referring to the damage that excessive competition can cause if it is not properly balanced with other appropriate regulatory measures.\textsuperscript{260} The authorities must be sensitive to the difficulties that unregulated competition can create, such as through reducing regulatory and market standards (as with offering high LTV loans to unsuitable borrowers in both sub-prime and prime markets)\textsuperscript{261} or creating high levels of concentration and dominant positions (as with the Lloyds Banking Group (LBG) in the United Kingdom). Competition policy must be balanced with financial stability and other protection objectives. This policy also raises the wider issue, referred to in the Turner Review, of the extent to which authorities should attempt to regulate innovation and welfare benefit directly. Despite Lord Turner's invitation to do so, this policy must be resisted unless any separate risk management or consequent financial stability difficulty arises. Other consumer protection concerns should be principally dealt with through disclosure and financial capability rather than direct financial regulation.

J. Institutional Revision

The institutional structure of regulation has been reconsidered in many countries. This reconsideration includes the earlier aborted Hank Paulson recommendations in the United States that were subsequently replaced by the more moderate Treasury proposals under Tim Geithner in the June 2009 \textit{New Foundation} paper.\textsuperscript{262} The continuing principal objective must be to clarify regulatory function and responsibility at the same time as avoiding debilitating conflicts ("turf wars") and ensuring full regulatory coverage of all institutions that may create any systemic risk. The U.S. Treasury's original 2009 plans allowed for only limited simplification of the regulatory net (with the merger of the OTS and OCC within the Treasury), although they do represent an intelligent political compromise that may not otherwise have received necessary Congressional approval.\textsuperscript{263} Whether and in what form the plans may finally be adopted remains unclear, especially with all of the other significant reform measures before Congress demanding legislative time.

\textsuperscript{259} See id. § 6-7.
\textsuperscript{260} Final Remuneration Code of Practice, Cm. 7667.
\textsuperscript{261} Id. pt. E.
The U.K. government has confirmed that it supports the single integrated regulatory structure set up under the FSMA although the Conservative opposition publicly announced in July 2009 that it would transfer regulatory function to a strengthened Bank of England and restructure the FSA as a more limited consumer protection agency. 264 This proposal was somewhat surprisingly supported by The Economist. The main omission with these proposals is simply that while bank and insurance company supervision would be transferred back to the Bank of England under the Conservative plans, the crisis was not caused by the banking markets specifically, but by the unregulated mortgage sales markets in the United States and the excesses in the structured finance departments of the major investment houses on Wall Street and elsewhere that carry out securities business and not deposit taking (banking) under U.S. and U.K. laws. The British Conservative proposals are almost silent on securities and market regulation. It is also arguable that wholesale money and capital markets have become so integrated and inter-connected in recent times that they should be regulated together insofar as possible with any moves to break up an already integrated oversight regime under the FSMA being regressive and ill-informed.

Of more importance in terms of institutional reform has been the creation of new multi-agency financial stability oversight entities. These include the U.S. Financial Services Oversight Council (FSOC), the European Systemic Risk Board (ESRB), the U.K. Council for Financial Stability (CFS), as well as the new separate Financial Stability Subcommittee (FSC) within the Bank of England. The role and function of the U.K. FSC has since been clarified in the Financial Services Bill. 265 The international FSF was also formally re-designated the Financial Stability Board (FSB) following the London G20 Summit. 266 This focus on "systemic" (in the language of the ‘Treasury White Paper’) or "macro-prudential" oversight (under the Turner Review) is to be fully supported as it was one of the core official pre-crisis failures that arose.

K. FINANCIAL STABILITY AND MARKET SUPPORT

Substantial difficulties nevertheless remain in developing any meaningful financial stability policy in practice. Separate work streams are, for example, being taken forward within the IMF and the Bank of England with this issue also being considered by the FSB and by the BIS in its recent Annual Reports. 267 Many measures and indicators have to be taken into account in initially identifying potential vulnerabilities. These vulnerabilities have to be assessed and prioritized, which can only be regarded as a matter of judgment. Effective tools must then be made available to attempt to give effect to any intervention
decisions agreed. Unfortunately, only limited options have been identified at this stage (including higher and counter-cyclical capital charging or interest rates), although these may have other distortional and contradictory or conflicting effects. A key issue not referred to in any of the papers to date also appears to be the need to attempt to balance regulatory with monetary, economic, fiscal, competition, and other consumer protection policies.

The Bank of England issued an important recent discussion paper on The Role of Macro-Prudential Policy in November 2009. This study assesses how risk across the financial system as a whole (referred to as systemic risk) can be dealt with through a "reorientation" of prudential regulation and prudential regulatory tools. The paper reviews the role and function of monetary policy in modern markets and defines systemic risk in terms of aggregate (cycle) and network (connectivity) effects. Market failure is defined in terms of lack of effective incentives, information, and co-ordination with the primary exposure propagation channels being leverage (solvency) and maturity transformation (liquidity).

This is an important paper in providing a first full and substantial study of the meaning of the financial stability and some of the main means of managing it in practice. The unfortunate, but almost inevitable, conclusion drawn is nevertheless that more traditional monetary policy tools, including principally interest rates, are not suitable for controlling systemic risk. The authorities are then forced to rely on a further level of counter-cyclical capital charging, managed through the central bank or other systemic regulator, in addition to all of the other "Basel III" higher capital charges to be implemented by the financial regulator at the micro level. Banks will then be subject to substantial parallel and supplementary new micro and macro capital supplements in addition to the bonus and other penalty taxes already announced in the United States, United Kingdom, and elsewhere, as well as the proposed new global financial stability levy recently supported by the IMF. All of this may simply destroy the underlying credit intermediation process or, at minimum, substantially limit the amount and increase the cost of credit available to companies and households. Difficult issues still remain to be resolved in this area.

Effective support mechanisms must also be set up in all countries. These mechanisms must operate based on a combination of individual institution liquidity support, capital support, guarantee support, possible asset purchase, and direct credit (quantitative easing) where necessary. Where the government acquires a stake in private financial institution, it should be returned to the market as soon as possible. Financial institutions should be made as robust as possible, including maintaining effective contingency planning, as well as winding-up policies in the event of their own closure. Market confidence is nevertheless ultimately dependent on the availability of necessary official support arrangements in the event of a major crisis. The provision of market support is an issue on which regulators and regulatory reform papers have become almost silent. Financial institutions must be substantially strengthened especially in terms of capital, liquidity, and governance, al-

269. Id. The Bank does not provide any specific definition of macro-prudential policy.
270. Id.
271. Id.
though market confidence is ultimately dependent on effective market support and only on official market support.

L. POLICY CONFLICT

The two residual issues that remain to be resolved are then concerned with welfare balance and allocation of market support costs. Market cycles are natural processes and maximum welfare benefit will only arise where economies can grow and expand in as unrestricted a manner as possible. The objective should not be to attempt to remove natural cycles, but only to limit their more damaging extremes and the more debilitating effects of any downturns, and, in particular, prevent any more severe crashes or crises as experienced over the last two years.

In the event of a major crisis, the authorities must be willing and able to take all necessary action to prevent the most devastating consequences through extended lender of last resort and other support operations. An official contingent support liability or responsibility arises in all cases and appropriate arrangements must be in place for this purpose. This support is essential to maintain market confidence in all extreme cases, although it necessarily involves an allocation of cost between the public and private sectors through financial support and financial regulation.

Modern economies ultimately depend on achieving the most appropriate balance between allowing open competitive markets (and natural and moderate cycles) to evolve at the same time as imposing necessary costs and obligations on market operators to ensure their stability, and at the same time protecting the stable and efficient operation of the markets as a whole. Excessive or distortional regulatory costs must be avoided where these only limit credit supply, growth, and welfare benefit, although these must also be set against the potentially unlimited liability of the state in making support available in all necessary cases. The objective of modern financial regulation must then be to find a new balance between innovation and credit supply with stable private financial institutions and private capital markets being secured at low public cost.

VIII. U.K. Policy Conclusions

The global financial crisis was a complex event. It is impossible to identify any single cause, fault, or blame, despite the more hysterical press and media attempts to do so. A large number of factors came together to create the underlying conditions within which markets became increasingly vulnerable and unstable. Once a specific trigger event occurred (and specifically, the Lehman closure), other factors produced contagious and cyclic effects with others aggravating and magnifying the damage and contraction caused. Complex problems require carefully considered, informed, and appropriately balanced composite solutions.

A significant number of studies and papers have been issued on the crisis with an even larger number of opinions and recommendations made for reform. Many common elements arise, although care still must be exercised where regulators claim that there is clear consensus on certain matters (such as counter-cyclical capital charging) where this only reflects their own opinion, preference, or negotiating position. Many of the recommendations also simply operate on a delegated or postponed basis by instructing, directing,
simply transferring responsibility to another agency or technical committees to take the matter covered forward. Many of the issues raised are highly complex and sensitive, and it may take some time before any meaningful understanding and agreement can be secured. Initial regulatory delegation may then simply be followed by regulatory delay (dispute or disagreement) and eventual regulatory compromise (gap or omission). The danger is to avoid replacing earlier irrational market exuberance with an even more irrational and equally damaging official or regulatory over-reaction.

The emerging U.K. response is essentially based on an as yet unspecified increase in total capital and liquidity levels, enhanced supervision and enforcement, strengthened corporate governance within bank boards, including more careful oversight of remuneration packages (based on risk assessment, deferral, performance conditions, and possible clawback), a new special resolution (SRR) regime with strengthened deposit protection, and the proposed creation of a new Council for Financial Stability (CFS) to manage systemic oversight. This response can then be summarized in terms of reserves, governance, resolution, compensation, and macro-prudential supervision. The main gap in the United Kingdom remains effective market support with any further central bank capital or funding arrangements being left to be managed by the Bank of England as part of the revision of its Red Book. This particular response is inadequate and a major omission as both market and consumer confidence are ultimately dependent on effective support in the most extreme crisis.

The residual difficulty that all countries and other agencies will have to resolve is how to manage macro-prudential financial stability going forward. The necessary solution remains an unclear, unspecified, and an untested area. An effective macro-prudential or systemic stability policy will have to be constructed with all necessary and relevant indicators being taken into account and appropriate implementation tools being made available to give this effect in practice. National policy and target or strategy conflicts will have to be resolved, while much more substantial cooperation and coordination will have to be achieved at the regional and international levels. This resolution will specifically involve balancing a number of possibly conflicting policy objectives. Market stability is ultimately dependent on strong regulatory policy with effective monetary policy, economic policy, fiscal economy, and competition or consumer policy. Meaningful policy integration must also then be achieved from a national, regional, and global perspective. This remains a significant challenge still to be resolved.

We have lived through the most devastating and debilitating crisis for many years. The extended Great Moderation and Great Stability that everyone benefited from came to an abrupt and severe end in summer 2007. This crisis has nevertheless created an equally significant opportunity to reconsider fundamental issues with regard to the structure and operation of modern financial markets, financial market control, and financial benefit. It also has to be expected that the crisis may have been even worse if its correction had been delayed even longer. Official policy has since then moved away from unrestricted open liberal markets to a more constrained and directed environment, although this issue was always only a question of balance. It must not be forgotten that massive benefits were experienced during the extended period of financial stability and economic growth that almost all countries enjoyed over the last two and a half decades. The objective must now be to pursue future innovation and growth within a new more sophisticated, but not necessarily less flexible or innovative framework, within which all relevant vulnerabilities and
exposures are taken into account and properly managed and balanced. It may still be possible to construct a new financial market order that can deliver opportunity and benefit without the same dangers of destructive future instability and collapse.