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Global Financial Sector Reform: The Single Financial Regulator Model Based on the United Kingdom FSA Experience—A Critical Reevaluation

Joseph J. Norton*

I. Introduction

There exists a current global trend among developed and developing countries to adopt or to consider the adoption of a unified ("mega") financial regulator structure, based largely upon the perceived success of the recent United Kingdom (UK) experience. The primary purpose of this article is to attempt, from a policy and retrospective vantage point, to re-evaluate the efficiency, efficacy, and relevance of the UK's mega-regulator for financial institutions, the Financial Services Authority (FSA), as a viable international regulatory model of choice with respect to global financial sector reform structures. In doing so, this article also will consider the "completeness" (or, more accurately the "incompleteness") of the UK's regulatory approach *vis-à-vis* two important collateral regulatory issues: (1) the *unitary* versus *functional* regulation debate; and (2) the interfacing of a mega-regulator model with the need for a modern deposit insurance/compensation scheme that is designed not just for protecting depositors but also for bolstering financial stability. The main proposition presented by the author is that the adoption of the UK-FSA, for global financial sector reform purposes, needs to be understood within and largely limited to the particularities of the UK historical backdrop, and that this regulatory model (while not without its virtues) should *not* be uncritically looked to (in any wholesale transplantation mode) as an international benchmark for future global financial sector reform. As to the debate of unitary versus functional regulation, again there appears to be no one conclusive answer or approach—with a range of variant approaches possible. With respect to deposit insurance, a

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separate and independent "modern" scheme is advocated, unlike that currently employed by the UK; albeit, developing, emerging and transitioning countries should look at this issue in a "sequenced" manner.

The audience for this article is intended to be lawmakers, policymakers and concerned industry participants with respect to the financial industries sector in developed and developing economies who may be presently considering or who may come to consider in the future the adoption of a UK-FSA type of unified regulatory framework. It is hoped that this article will provide helpful background and policy information for these governmental authorities and industry participants when considering the *pros* and *cons* of the adoption of an FSA mega-regulator structure.

For background purposes, selective introductory observations are provided in Part II of this article as to the general regulatory policy issues involved, and in Part III as to the legal and organizational nature of the FSA. In making his evaluations, this author focuses in Part IV on the respective practical experiences of the UK-FSA. Part V then touches upon the two collateral regulatory issues referred to above. In concluding, Part VI endeavours to provide a set of meaningful conclusions drawn from and "lessons to be learned" with regard to the new UK regulatory scheme generally and with regard to the two collateral issues considered in this article.

II. The Backdrop

A. The Subject In General

In recent times, the formation of a unified mega-financial regulator has become increasingly common in a number of countries. Most often, this radical "regulatory jump" has arisen as a reactionary response to significant, local financial and political factors, including the demands arising from a perceived integration of financial markets and perceived deficiencies in traditional supervisory and regulatory systems demonstrated by recent financial crises. This trend of creating single mega-regulators started on a limited and particularized basis (keeping the deposit insurer separate) in Scandinavia in the mid 1980s;[1] but, the primary structural catalyst and focus for the recent proliferation of this mega-regulatory structural reform has been the creation of the UK-FSA in 1997.[2] As will be discussed hereafter, the UK experiment was without the benefit of any comprehensive policy study and debate as to the efficiency, efficacy and cost-benefit of such a radical regulatory venture or as to

1. Norway established an independent unified banking and insurance regulator in 1986; Denmark in 1988; and Sweden in 1991. Finland followed in 1993, but linked their FSA to the central bank, Bank of Finland. The Nordic countries have small and consolidated financial markets, have some prior experience with regulatory consolidation, and suffered a series of financial crises in the 1980 and early 1990s. In terms of the impact on the deposit insurer, in Norway the Guarantee Fund is a legally separate organization from other public and private bodies; the Danish Fund is a self-governing body, supervised by its FSA; the Swedish Deposit Guarantee Board is independent from its FSA; and the Finnish Fund is operationally independent, though supervised by its FSA. *See* Michael Taylor & Alex Fleming, *Integrated Financial Supervision Lessons of Northern European Experience*, World Bank (September 1999). *See also* Aligning Financial Supervisory Structure with Country Needs (Alexander Fleming, David T. Llewellyn, & Jeffrey Carmichael eds., 2003) [hereinafter World Bank 2003 Financial Structure Program]. *See generally*, International Association of Deposit Insurers (IADI), *at* http://www.iadi.org.

2. As discussed *infra*, the UK-FSA has become one of the largest and most complex unified financial regulators in the world, having regard to the size of London's financial markets.

the relation of such a scheme as to such major modern areas of regulatory concern as the role of the deposit insurer and the relevance of a general functional versus entity approach to financial regulatory supervision.

B. Developing Countries

It should be kept in mind that the UK-FSA was never intended or designed to serve as an international model.[3] Notwithstanding this, the UK-FSA (although designed for a highly developed and concentrated financial system) has come to be viewed by a number of governmental and intergovernmental authorities in developing countries as a feasible and viable regulatory model. In fact, the primary subjects of this post-1997 reform trend to consider a mega-regulator model have been developing, emerging, and transitioning economies.[4] Most of these countries (totally unlike the UK) were starting at a near *'ground-zero'* basis as to financial sector development and/or in reaction to recently occurring major financial market/sector and/or political crises: the starting-point, model-of-choice for these countries, most often, however has been to consider the UK-FSA model.[5]

In the financial sector law reform experience of this author in a range of developing, emerging, and transitioning countries since 1997, the UK model has been of considerable interest to these type of countries, in large measure, because it is a recent (unconnected with, but following closely on the heels of the Asian Financial Crisis) and is a consolidated model, with a unified rulebook (*Handbook*) that, at least superficially, implies a degree of manageability, if not simplicity. Also, it is a model that appeals not just to the developing country but to the international financial institution (IFI) and regional financial institution (RFI) experts providing these countries with technical assistance under some form of "conditionality," "EU acquis" arrangement or mutually agreed cooperative arrangement. In effect, from a bureaucratic standpoint, the UK model appears easy to deal with in the initial adoption stage of the reform process, as it presents itself as a "pre-packaged model." For example, while the IFIs and RFIs will never overtly require a specific model, the UK mega-

3. *See e.g.*, Michael Foot, UK-FSA Managing Director (Deposit Takers and Markets Directorate) has recently stated: "We have never said that the UK model was one that other countries should follow. And we recognise that there are features of the UK (such as the fact that most of the financial service sector is concentrated in London) that has helped the creation of the FSA. . . ." Foot also acknowledges that in adopting any FSA model there cannot be a takeover by one of the existing regulators but there needs to be a new organisation; that there are no "quick (regulatory) fixes"; and that "it will take years to get all the potential benefits from the new organisation." FSA-UK Managing Director shares his views on integrated supervision and deposit protection, PDIC Forum, Vol. 2, No. 1, available at http://www.pdic.gov.ph/dab/Forum-2nd_issue_june2004.pdf (June 2004). *Cf.* Howard Davies, *Integrated Regulation in the UK and Lessons for Others*, in World Bank 2003 Financial Structure Program, *supra* note 1, who suggests that, subject to a series of preconditions to be met, the UK model may have broader international appeal and relevance. It should be noted that most of his "preconditions" would not be met by most developing countries.

4. Many emerging economies that have experienced financial crises have recently reformed their financial regulators into a single regulator, including South Korea, Singapore, Colombia, El Salvador, Malaysia, Mauritius, Mexico, Paraguay, Peru, and Venezuela. Others considering a unified financial regulator are Bulgaria, Kazakhstan, Poland, Slovakia, Slovenia, South Africa, Ukraine and Indonesia: Estonia (see discussion *infra* note 7) adopted a rather unique variation in 2002. *See* José de Luna Martínez & Thomas A. Rose, *International Survey of Integrated Financial Sector Supervision*, World Bank Policy Research Working Paper 3096 (July 2003).

5. *See generally* Joseph J. Norton, Financial Sector Law Reform in Emerging Economies (2000) [hereinafter Norton-Emerging Economies] (specifically chapter 3).

regulator model is technically easier for these experts to deal with for these institutions, so the external experts will often "lead" the country to this "watering-hole."[6]

The adoption of the FSA model can be done wholesale or on a modified or highly individualized basis. For example, a small transitioning country seeking EU entry, Estonia, opted for a FSA-like approach, but one which remained encapsulated within the country's Central Bank framework; though in case of a bank failure the end-payer will be the Estonian taxpayer and not the Central Bank. Estonia has small, incipient financial markets, with the Central Bank having the repository of the limited, skilled bureaucratic personnel existing in the country. While keeping the new regulatory framework within the overall Central Bank structure, the Estonians have tried to put the new unified regulator within a segregated and "fire-walled" structure with the Bank.[7]

As a practical matter, the key ongoing structural role of the Central Bank in developing countries is most often the most sensible alternative to take; though, at least from the UK-FSA perspective, it needs to be borne in mind that a primary objective of the UK model is to dislodge bank and financial supervision from the Central Bank.[8] Whether the mega-regulator model or the FSA model is appropriate for emerging market countries will be the subject of subsection V.A.3.

C. Industrialized Countries

It is also true a number of industrialized countries have opted for some form of UK-FSA type model. For example, Japan has recently adopted a modified FSA-type model; however, it has adopted a much different scheme as to dealing with its deposit insurer than did the U.K.[9] In addition, the apparent "follow-the-leader" approach taken by Germany recently when pressured by the European Union (EU) and the European Central Bank System (ECBS) to restructure its bank supervisory framework and to insulate further the Bundesbank in its monetary policy functions has led to the adoption of a far less comprehensive and less regulatory intrusive single-regulator from the UK pattern and to one that effectively left its prior compensation scheme approach intact.[10] Further, an industrialized country such as the United States (having the most developed and comprehensive financial system in the world), in the mid-late 1990s, went through a period of major regulatory reform debate that specifically rejected regulatory consolidation in favour of maintaining segregated, but coordinated *functional regulation* (*i.e.*, regulation geared to the specific activities such as banking, insurance, or securities, and often exercised by a separate specialized regulator) and the maintenance of a strong, comprehensive and independent deposit in-

6. We have witnessed several examples where U.S. experts have encouraged this model to emerging economies, while at home the United States has strongly rejected the unitary model in favour of separate, functional regulation.

7. *See* Financial Supervision Authority Act (Estonia) passed May 9, 2001. For a discussion of this Act, *see* Andres Trink, *Challenges for the Estonian Unified Financial Sector Supervision*, Eesti Pank Bulletin No. 7 (2001); *Creating on Effective Regulatory Culture: the Case of Estonia in* World Bank 2003 Financial Structure Program, *supra* note 1.

8. *See* Norton-Emerging Economies, *supra* note 5, sec. 4.3.

9. On Japan's adoption of an FSA-like regulatory framework, *see* companion article authored by Dr. M. Yokoi-Arai contained in the Symposium section of this journal's instant issue.

10. On Germany's recent adoptions of a form of FSA, *see* companion article authored by Dr. J-H Binder and contained in the Symposium section of this journal's instant issue.

surer.[11] Moreover, Australia has come up with its own very interesting ("Twin Peaks" variant) regulatory reform model based on a concept of objective-based regulation (*i.e.*, regulation geared to specific governmental objectives such as financial stability, consumer protection, market abuse/integrity).[12]

D. General Policy Rationale

In any event, it needs to be kept clearly in mind at the outset that, in fact, no theoretically absolute or otherwise clear and compelling criteria exist, at the present, in determining the choice between single or multiple, functional regulators (or, for that matter for an "umbrella" regulation within which functional regulation occurs). For all of the main policy, institutional, and operational arguments that can be mustered in favour of a single regulator, a corresponding, countervailing series of disadvantages can be identified. Further, each country situation is *sui generis*, with the best, informed decision dependent on and taking regard of local historical, social, economic, financial market, regulatory, and political factors and conditions.[13]

While the particular reason(s) for the establishment or non-establishment of a unified financial regulator may be different for each country, it appears to be a superficially prevalent belief that a unified financial regulator can enable a country to better rationalise its financial regulation and to better preserve greater financial stability. For emerging economies, it is also hoped that such perceived effects will result in an attraction of increased foreign investment. Nevertheless, the relative arguments for and against the construction of a single regulator are complex and individualized. Moreover, as will be explained throughout this article, the actual UK domestic experience with the FSA, by itself, fails to present a compellingly convincing practical case for other countries to undertake such major regulatory consolidation: the verdict from the UK and other adopting country experiences is still pending.

However, the issue of whether there should be a single regulator for all financial sectors is only a threshold consideration that leads to a number of collateral policy issues. For instance, the choice of a mega-regulatory structure does not necessarily determine: (1) whether the exercise of regulatory authority under the mega-regulator umbrella should be on a unitary or functional basis as to the differing financial sectors; (2) whether all the financial sectors should be governed by unified rules; or (3) whether the mega-structure should subsume and determine the nature and structure of the related deposit insurance scheme (or for that matter, as to this latter point, whether there should be a common compensation scheme

11. *See* Gramm-Leach Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12 U.S.C. and 15 U.S.C.). *See also* discussion *infra* in section V A1 of this article.

12. *See Financial System Inquiry Final Report*, Commonwealth of Australia (Mar. 1997) [hereinafter the Wallis Report]. For further discussion of the Australian approach, *see* Jeffrey Carmichael, *The framework for financial supervision: macro and micro issues*, BIS Policy Paper (Nov. 1999); *Australia's Approach to Regulatory Reform*, World Bank 2003 Financial Structure Program, *supra* note 1.

13. The papers presented at the World Bank 2003 Financial Structure Program, *supra* note 1, contain a range of policy views and country experiences with regulatory integration. *See also* G. A. Walker, *United Kingdom Regulatory Reform: A New Beginning in Policy and Programme Construction*, *in* Financial Regulation: A Guide to Structural Reform (Douglas W. Arner & Jan-juy Lin eds., 2003). The key issue most often becomes one of subsequent or consequent corrective adjustment based upon a careful policy and practical analyses of such conditions and factors.

for all the financial sectors). Determinations as to these options should be considered separately in attempting to develop any meaningful final conclusions with regard to the efficiency or efficacy of any particular system and set of supporting domestic arrangements. Sections V A-C of this article will address collateral issues (1) and (2) above and Section V D will consider collateral issue (3) above.

Substantially differing policy and practical considerations are entailed in each of these collateral governmental considerations.[14] Generally speaking, a number of separate policy, institutional, and operational factors can be compared in assessing whether a single or multiple sector-based regulatory solution would be more appropriate. Against the advantages of policy integration, consistency, simplicity, ease of review, and flexibility of policy development have to be considered separate sector risk requirements, possible lender-of-last resort (LLR) and moral hazard confusion, a consequent lack of reputational incentives and conflicts, loss of specialist service providers, and the need for additional protection for dedicated interest groups. In institutional terms, improved administrative control, increased contact and communication, better allocation and use of resources, improved training, and enhanced internal and external accountability have to be balanced with possibly excessive size and administrative complexity, potential conflicts of interest and regulatory culture, abuse of power, additional and specialist training demands, and confused or reduced accountability.[15] As to the latter collateral issue of how to treat the deposit insurer, a country needs to determine initially what it expects of its deposit insurer and should also consider the prevailing international trends for a modern deposit insurance system.[16]

With regard to operational or implementation issues, operational efficiency (including economies of scope and scale, simplified management and administrative structures, and improved expertise and experience), increased responsiveness, flexibility, reduced cost, and the elimination of cross-sector competition have to be considered against inherent operational inefficiency, supporting slow decision-taking and response times, the danger of over-standardised responses, increased costs in certain areas and more general loss of regulatory competition, and consequent incentives and internal accountability as well as high levels of

14. For further discussion of these general policy tensions, *see generally* Michael Taylor, "*Twin Peaks*": *A regulatory structure for the new century*, Centre for the Study of Financial Innovation (CFSI) Dec. 1995 [hereinafter Taylor, *Twin Peaks*]; Michael Taylor, *Peak Practice: How to reform the UK's regulatory system*, Centre for the Study of Financial Innovation (CSFI) October 1996; Michael Taylor, REGULATORY LEVIATHAN: WILL SUPER-SIB WORK? (1997); and M. Hall, *All Change at the Bank of England*, 7 JIBFL 295 (1997). *See also* R. Monro-Davies, *Where Angels Fear to Tread?*, 6 JIBFL 241 (1997); D. Turing & M. Sah, *NEWRO: Getting it Right*, 9 JIBFL 4.11 (1997). *See also*, Andrew Hilton, *UK Financial Supervision: A Blueprint for Change*, Centre for the Study of Financial Innocation (CFSI), May 1994; CHARLES A. E. GOODHART, ET AL., FINANCIAL REGULATION: WHY, HOW AND WHERE NOW? (1997); Clive Briault, *The Rationale for a Single National Financial Services Regulator*, FSA Occasional Paper 2, May 1999; Clive Briault, *Revisiting the rationale for a single national financial services regulator*, FSA Occasional Paper 16, Feb. 2002. *See, e.g.*, Dirk Schoenmaker, *Institutional Separation between Supervisory and Monetary Agencies*, Financial Markets Group (FMG) (Jan. 1992). *See also*, on the general debate, Christine Fay & Nicolas Parent, *The Organizational Structure of Financial Market Regulation: Highlights from the Literature, in* Bank of Canada, Financial System Review, at 58: "[I]t is apparent that the literature on the organizational structure of financial markets offers many different points of view on the optimal means of regulation. While it helps to put the current debate surrounding the regulation . . . in perspective, the literature does not point to a single 'optimal' solution."

15. *See infra* subsection V A.1.

16. *See infra* section V B.

consequent regulatory concentration.[17] Arguments can again be developed for and against an integrated LLR and financial regulator. The arguments against monetary and regulatory policy separation include the need to maintain an essential link between the LLR function and the conduct of supervisory policy, consequent payment system support with the central bank generally also being responsible for payment system stability, and the need for basic policy consistency in both areas. The arguments against an integrated monetary and regulatory policy include potential conflicts of interest or policy objectives, consequent credibility problems with the maintenance of price stability as the key objective of the central bank, and functional diversity in product or service development.[18]

E. A Brief Note on Legal Transplants

The multiple dilemmas presented by the introduction of new and "foreign" regulatory structures and rules into the financial sector area of a domestic jurisdiction are often brushed aside. It is nearly as if modern financial sector reform issues present subject-matter not previously addressed by the domestic system(s) and therefore create a "void" within which new regulatory reforms and models can be imposed in a near "top-down," wholesale manner.[19] However, what appears to be often forgotten for the policymaker and lawmaker is that such reforms need to mesh with the existing regulatory, economic, social, and cultural environments of the particular domestic jurisdiction. For example, imposing modern reforms will presuppose the existence of a similarly developed working and complimentary financial sector legal infrastructure: this would include current levels of sound regulatory/supervisory development and sophistication, the existence of quality transparent and fair administration procedures, the presence of a sound enforcement system, and the embedding of a well-trained and developed judiciary.[20]

Thus, modern financial sector reforms really should not be transplanted wholesale simply because there is perceived to be some form of "blank slate" or "vacuum" present on or in which the new structures can be integrated. Stepping back, one needs to realize that the introduction of a "mega-regulatory" model presumes the existence of a highly developed financial sector as well as established legal, administrative and judicial environments-nevermind, of relevant bank and other financial markets that are at a developmental stage where a confluence or convergence of financial markets, service, and institutions is appearing and might lend itself to a unitary regulatory structure.[21] Moreover, even if such preconditions can be assumed, there is still no inevitability that a jurisdiction will "well-receive" a UK-FSA model (*e.g.*, consider the U.S. financial sector system).

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17. *See, inter alia*, Richard K. Abrams & Michael W. Taylor, *Assessing the Case for Unified Financial Sector Supervision*, *in* Financial Regulation: A Guide to Structural Reform, *supra* note 13.

18. Michael Taylor, 'Chapter 2 The Policy Background' *in* Blackstone's Guide to the Financial Services & Markets Act 2000 (Michael Blair et al. eds., 2001). *See generally*, G. A. Walker, *Deposit Protection in the United Kingdom in* Joseph J. Norton et al., Legal Aspects of Depositor Protection Schemes: Comparative Perspectives. Paper presented at International Seminar on Legal and Regulatory Aspects of Financial Stability (Jan. 21-23, 2002).

19. *See* Katharina Pistor, *The Standardization of Law and Its Effect on Developing Economies*, G-24 Discussion Paper Series No. 4., June 2000.

20. *See generally* Norton-Emerging Economies, *supra* note 5.

21. *Id.*

This question of "reception" of foreign legal elements is indeed an ancient debate.[22] The point being made, for present purposes, is that an analysis of the "receptability" issue for the FSA model or for any other major financial sector reform relying on "foreign" (which includes international) models and standards should not be neglected, as at minimum the local environment will determine the ultimate degree of reception and of the final shape of the imposed reform and its implementation.[23]

III. Overview of the UK-FSA Regulatory Structure

A. Historical/Policy Background to UK-FSA

Prior to the enactment of the Banking Act in 1979, the UK lacked a formal authorisation regime for its banking sector, relying on the "moral suasion" exercised by the Bank of England and self-regulation of organised bodies such as the Accepting Houses Committees and the London Discount Market Association. The Banking Act of 1979 was enacted in response to the 'secondary banking crisis' during 1972-73 and to the need for the UK to set up a formal regulatory regime in the banking area under the First European Community Banking Directive in 1977. The 1979 Act nevertheless attempted to preserve the relationship of the Bank of England and the banking sector while incorporating authorisation and supervision of the secondary sector. The Banking Act of 1979 accordingly retained the distinction between "recognised banks" (the primary sector) and "licensed deposit takers" (the secondary sector institutions). The Banking Act of 1979 was subsequently replaced by the Banking Act of 1987, with the earlier inefficiencies of the former dual approach towards recognised banks being abolished.[24] Despite the extensive new powers that were conferred on the Bank of England, it was perceived that the Bank was still struggling to discharge its statutory responsibilities.[25]

The separate review of investor protection conducted by Professor Gower also prompted the Government to introduce changes to the self-regulatory regime that operated in the securities area. The Government then introduced a bill, which subsequently became the Financial Services Act 1986, to preempt some of the more extreme proposals made by Professor Gower. The Financial Services Act of 1987 delegated powers to a new Securities and Investment Board (SIB), the function of which was to oversee the recognition and operation of a number of self-regulatory organisations (SROs) that would regulate particular aspects of the securities markets within the UK.

UK banking regulation also had become subject to increasingly prescriptive regulation under the further European Community Directives that were being adopted under its "single market programme,"[26] while the UK securities regulators developed increasingly more

22. *See, e.g.*, Alan Watson, Legal Transplants (2d ed. 1993) (particularly chapter 4).

23. *Compare* divergent, but subsequently narrowed perspectives of Otto Kahn-Freund, *On Uses and Misuses of Comparative Law*, 37 Mod. L. Rev. 1 (1974) *with* Alan Watson, *Legal Transplants and Law Reform*, 92 L. Q. Rev. 79 (1976) (who has tempered his split with Kahn-Freund in Watson, *supra* note 22, "Afterward").

24. *See, e.g.*, Joseph J. Norton, *The Bank of England's Lament*, *in* Bank Regulation and Supervision in the 1990s (Joseph J. Norton ed., 1991).

25. Namely, the failure of Johnson Matthey Bankers, a recognised bank under the 1979 Banking Act revealed the limitation of Bank of England's information gather powers of recognised banks. The Bingham Report on the collapse of the Bank of Credit and Commerce International (BCCI), also discussed the failures of the BCCI and of Barings in 1995 as occasions where the appropriateness of the Bank's supervision was questioned.

26. Council Directive 77/780/EEC, 1997 O.J. (L322) 30 ("First Banking Co-ordination Directive").

complex 'rulebooks' under the authority conferred under the 1986 Financial Services Act to govern the behaviour of securities firms.

The most fundamental reform of financial regulation within the UK came to be announced immediately after the May 1997 general election by the new incoming Labour Government. The new Chancellor of the Exchequer, Gordon Brown MP, announced on May 20, 1997, in a statement to the House of Commons that ". . . the distinctions between different types of financial institution—banks, securities firms and insurance companies—are becoming increasingly blurred."[27] This broad rationale, based on the realities of perceived modern financial market integration tendencies, would be used to justify the Government's radical and unexpected initiative for creating a single regulatory authority over summer 1997; though, underneath this was governmental dissatisfaction with the role of the Bank of England in handling such earlier crises as Johnson Mathey, BCCI, and Barings. While the Labour *Manifesto*[28] had promised reform and strengthening of financial regulation and a simplification of the structure and nature of the financial system, it had not set out how this would be achieved.

With the increasing criticism of the regulatory structure of the UK financial sector, this traditional (but largely non-transparent and discretion-based) structure had been slowly and carefully developed over a long time. The Government's announcement, which was announced subsequent to and separate from the decision to grant the Bank full monetary independence, was particularly monumental in that it would annul ancient City traditions in favour of a comprehensive and prescriptive statutory-based regulatory regime. The decision was also radical in that, while establishing central bank independence for the Bank of England, it would now remove the supervisory ambit from the Bank supposedly to insulate the Bank's monetary independence from any further financial crises or scandals. In the background, there was also the need to combat financial crime, as to which adequate powers did not exist, and to make the regulatory environment more transparent for all involved and affected parties.[29] Thus, a threshold precipitating factor for the UK reform was the policy decision to separate bank regulation, supervision and enforcement from the central bank, leaving a major regulatory structural vacuum to fill.

In hindsight, the financial regulatory structure, prior to the establishment of the FSA, was seriously deficient in various ways. The former regulatory regime was fragmented with the risk of inconsistent regulation and regulatory arbitrage, and it could not respond to the fast-moving financial services market where functional industry/product distinctions were eroding.[30] The lines of responsibility were unclear, creating jurisdictional issues; and, there was little effective co-ordination among the various agencies.[31]

On the other hand, the relationship between the Bank of England and the effective operation of its lender-of-last resort function may have been better positioned previously

27. Gordon Brown, The Chancellor's Statement to the House of Commons on the Bank of England (May 20, 1997).

28. Labour Party, *New Labour, New Life for Britain* (1996).

29. Taylor, *Twin Peaks*, *supra* note 14, at 15.

30. OECD, OECD Reviews of Regulatory Reform: United Kingdom: Challenges at the Cutting Edge 38 (OECD 2002).

31. Christos Hadjiemmanuil, *Institutional Structure of Financial Regulation: A Trend Towards 'Megaregulators'?*, *in* Financial Regulation: A Guide to Structural Reform 184 (D. Arner & J.J. Lin eds., Thomson, Sweet & Maxwell Asia, 2003).

when the Bank of England was the banking regulator. This may have facilitated better informed decisions on liquidity support.[32]

When considering the pre-FSA regulatory structure against the measures for regulatory efficiency, the following observations can be made:

- **Clear objectives:** While the investor protection objective was becoming increasingly important, this was not incorporated into the objective of regulation, but was lead by self-regulating bodies (the SROs).
- **Independence, accountability, integrity and adequate resources:** The Financial Services Act of 1987 assisted in improving the independence and accountability of the SROs. However, the SROs were primarily industry-based and the disinterested credibility of such organisations operating with independent integrity was marginal, at best.[33]
- **Transparency:** Various financial debacles exposed the lack of transparency of the regulatory system. The failure of BCCI, Johnson Mathey, Barings and the Maxwell Group exposed time and time again the lack of transparency of the regulatory bodies.[34]
- **Limited Legitimacy:** Resulting from the fact that the SROs could only bind their members by contract, limited legitimacy created legal difficulties with respect to third parties and generally obstructed effective enforcement.[35]
- **Comprehensiveness of regulation:** The lack of comprehensiveness was perhaps one of the greatest problems of the pre-FSA regulatory structure. The fragmentation of the framework and the preferred reliance on informal 'moral suasion' and self-regulation created regulatory gaps and inconsistencies.[36]
- **Effective Implementation: Regulatory and Judicial Enforcement Timidity:** At the end of this day, a regulatory structure, as a practical matter, will be no more effective than the strength of the structure and its personnel regulator's commitment to vigorously stand behind, administer (implement) and enforce the new structure. Related to this will be the capacity and willingness of the judicial system to oversee (judicial review) and enforce the new structure. This element appears to have been lacking in the pre-FSA situation. In fact, it seems the SROs were more committed to avoiding strict enforcement, judicial confrontation, and the resulting publicity.
- **Cost-effective regulation:** One of the virtues of the pre-FSA regulatory structure was the cost element. The system was designed to facilitate flexibility in regulation. This limited the cost of forming regulations, although when an overall *cost-benefit analysis* is conducted, it is likely that the cost-effectiveness of the prior regulatory system would have been wanting.[37]

32. OECD, *supra* note 30, at 39.

33. *See* Hadjiemmanuil, *supra* note 31, at 183.

34. In the inquiry of the BCCI failure, the Bingham Report criticised the manner in which information of the failing bank was handled too late. 'Inquiry into the Supervision of The Bank of Credit and Commerce International' (Return to an Address of the House of Commons, Oct. 22, 1992).

35. *See* Hadjiemmanuil, *supra* note 31, at 183.

36. *See* Norton, *supra* note 24.

37. It was considered that the large number of different supervisors involved in the control of the main financial centres resulted in increased costs and reduced effectiveness of supervision. George Walker, *United Kingdom Regulatory Reform: A New Beginning in Policy and Programme Construction?, in* FINANCIAL REGULATION: A GUIDE TO STRUCTURAL REFORM 205 (D. Arner & J.J. Lin eds., Thomson, Sweet & Maxwell Asia, 2003).

B. FSA: Objectives, Accountability and Independence

The protracted (over 2-1/2 years of Parliamentary consideration as to implementation and not to any critical analyses of the supposed policy objectives of the legislation) and incredibly complicated development of the legislation in relation to the establishment of the UK FSA was carried out by the Securities Investment Board (SIB), which was to be renamed the FSA on its formal launch on 28 October 1997. The SIB had been a private company limited by guarantee, to which Ministers had transferred powers conferred on them under the 1997 Financial Services Act with the agreement of Parliament. The SIB was to assume direct responsibility for the banking and financial services regime following enactment of the Bill on financial regulatory reform.

The new Labour Chancellor asked Howard Davies, the then Deputy Governor of the Bank of England, to be the first chairman of the new FSA. The Chancellor also asked the retiring chairman of the SIB, Sir Andrew Large, to bring forward a plan to implement the policy for reform of financial regulation which was subsequently published in July 1997.[38] The *Large Report* envisaged that the new regulatory body would be responsible for prudential conduct (to maintain confidence in the financial system), conduct of business (to protect consumers of financial services) and market standards (to promote clean and orderly markets).[39] These are the bases of the objectives included in the subsequent Financial Services and Markets Act 2000.[40]

The handing-over of bank supervisory responsibilities was less expected than the unification of financial regulation. It appears, on the surface, that the impetus for this reform was prompted by the need to protect the Bank of England in discharging its new monetary responsibilities effectively without any potential disruptions being caused by further banking failures. The Bank accepted somewhat begrudgingly (actually the Bank appears to have had little, if any, say in the matter) that its role in the preservation of financial stability was more important than the preservation of its supervisory responsibilities.

The Treasury proposed the draft Financial Services and Markets Bill in July 1998 and eventually received its Royal Assent in June 2000.[41] The Financial Services and Markets Act (FSMA) is a highly complex and substantial piece of legislation, although it only provides a skeletal statutory framework.[42]

1. *Statutory Objectives*

The principles and objectives stated in the FSMA reflect largely those that were proposed in the *Large Report.*[43] These provide the criteria by which the FSA's performance is to be judged and are thus an important consideration to this *article*. The FSMA differs from its

38. SIB, Report to the Chancellor on the Reform of the Financial Regulatory System (Large Report) July 1997.

39. *Id.*

40. *See* Financial Services and Markets Act 2000 (Eng.) (FSMA 2000).

41. The Bill underwent two report stages in 1999 and was introduced to the House of Commons in June 1999. The Bill was carried over into the next session of Parliament in October 1999. The Bill was considered for a final time in the House of Lords in June 2000 leading to its Royal Assent two days later.

42. Part I of the FSMA put in place the framework for FSA's accountability. The regulatory objectives of the FSA are stipulated in sections 3 to 6. The institutional mechanism for accountability is specified in a series of provisions relating to the constitution and governance arrangements in sections 7 to 18.

43. *See supra* note 38.

preceding Acts in that the objectives are clearly defined and prominently displayed, enabling the discharge of its roles and functions to be identified more easily.[44]

There are four statutory objectives of the FSA:[45]

- Maintaining market confidence;[46]
- Promoting public awareness;[47]
- Protecting consumers;[48] and
- Reducing financial crime.[49]

The fourth objective is especially novel to the UK in that the previous regulatory bodies did not have the mandate or power to carry out this objective. The objectives are carried out in conjunction with the general functions of the FSA,[50] including rule-making,[51] the preparation and issuing of codes,[52] and the regulator's general policies.[53]

The 'market confidence' objective is defined as 'maintaining confidence in the financial system,'[54] including financial markets, exchanges, regulated activities and connected activities. While this objective aims to promote 'fair, efficient and transparent' markets in tandem with the IOSCO Objective and Principles,[55] it goes further in reflecting the global emphasis of financial stability.[56] The presence of systemic risk is the greatest threat to financial stability and is the primary objective of the reformed Bank of England.[57] Given the importance that financial stability has been attributed in the past decade,[58] it is surprising that it was not explicitly stated in FSMA. This was also the view of the Joint Committee on Financial Services and Markets, which discussed the Act. The objective was not defined as financial stability as this is the primary objective of the Bank of England and it could compromise the effective prudential supervision of individual institutions. As mentioned above, this was one of the reasons that banking supervision was removed from the Bank of England.

The solution to this has been for the FSA, Bank of England and the Treasury to exchange a Memorandum of Understanding (MOU) on systemic stability.[59] This MOU delineates the responsibilities as: the Bank is responsible for the 'overall stability of the financial system as a whole'.[60] The FSA is responsible for individual institutions, markets and clearing and

44. Generally stated in Financial Services and Market Act 2000 § 2(2).

45. *See generally* FSMA 2000 §§ 2(2), 3-6.

46. *Id.* § 3.

47. *Id.* § 4.

48. *Id.* § 5.

49. *Id.* § 6.

50. *See generally id.* § 2(4) and further sections.

51. *Id.* § 138.

52. *Id.* §§ 143-147.

53. *Id.* §§ 124-125.

54. *Id.* § 3(1).

55. IOSCO, OBJECTIVE AND PRINCIPLES OF SECURITIES REGULATION, *at* para 4.2.2 (May 2003).

56. FSA, A NEW REGULATOR FOR THE NEW MILLENNIUM, *at* 5 (Jan. 2000).

57. Financial stability is not a statutory objective of the Bank of England, however, it was laid out in the Chancellor's Statement on May 20, 1997, and subsequently agreed between the Bank, Treasury and the FSA on October 1997.

58. Culminating most importantly in the Financial Stability Forum. *See* http://www.fsforum.org/home/home.html (last updated Apr. 11, 2005).

59. *See* HM TREASURY, BANK OF ENGLAND AND FINANCIAL SERVICES AUTHORITY, MEMORANDUM OF UNDERSTANDING BETWEEN HM TREASURY, BANK OF ENGLAND AND FINANCIAL SERVICES AUTHORITY (Oct. 28, 1997).

60. *Id.*, para. 2.

settlement systems. Nevertheless, as the past experience of the UK in financial crisis displays, the problems of individual institutions and systemic problems often become difficult to distinguish.

The objectives of promotion of public awareness and consumer protection need to be considered in conjunction with each other as these issues come hand in hand. The rationale for promotion of public awareness is to correct the information asymmetry that exists between market participants, in particular for individual investors. Information asymmetry is perhaps the strongest cause of market failure and greater information disclosure, and availability to financial consumers would assist to rectify this problem. As a result of greater information, consumers would be better protected from financial risks of which they may not be aware.

The essence of disclosure of information to consumers is to alert users and potential users as to the risks associated with financial transactions. The UK financial market has traditionally dealt with this in the form of *caveat emptor*-let the buyer beware—whereby the producers and consumers are free to enter into financial transactions as long as the consumer is given full and accurate disclosure.[61]

However, the complexity of financial contracts and the various scandals of miss-selling in recent years have lead many to believe that this principle is insufficient. The concerns were resolved by including paragraph (c) in Section 5(2) of the Bill, which stipulates 'the needs that consumers may have for advice and accurate information' that is appropriate to the consumer.[62]

The reduction of financial crime includes crimes related to 'fraud or dishonesty'[63] and 'misconduct in, or misuse of information relating to, a financial market.'[64] The prevention of money laundering (and now of terrorism) has also become an important function of financial regulators in recent years.

2. *Independence, Accountability and Transparency*

The FSA is unique as a regulatory body in that it is a private company discharging a public function.[65] This quality has important implications towards its independence and accountability arrangements. The FSA is generally responsible for the conduct of its activities to the Treasury, instead of being subject to direct Parliamentary control. This reflects the traditional practice that incorporated bodies should not be directly answerable to Parliament and that it is for ministers to answer for the exercise or non-exercise of whatever powers they may possess. One, however, may query whether accountability to the Treasury, in fact, strengthens or diminishes the FSA's independence.

The Treasury appoints the Chairman and other members of the governing body of the FSA.[66] The FSA is required to make a report to the Treasury, at least annually, on the

61. Michael Taylor, *Accountability and Objectives of the FSA in* MICHAEL BLAIR, LORETTA MINGHELLA, MICHAEL TAYLOR, MARK THRIEPLAND & GEORGE WALKER, BLACKSTONE'S GUIDE TO THE FINANCIAL SERVICES & MARKETS ACT 2000 29 (2001).

62. The approach of distinguishing between retail and wholesale consumers, as taken in the US, was not adopted in the UK due to the unnecessary and burdensome conduct of business rules that would ensue. Instead, the consumer protection objective requires that the degree of protection take into account "the differing degrees of experience and expertise that different consumers may have . . ." FSMA 2000 § 5(2)(b).

63. *Id.* §. 6(3)(a).

64. *Id.* §. 6(3)(b).

65. *Id.* sch. 1, paras. 13, 14.

66. *Id.* sch. 1, para 2(3).

discharge of its functions, the extent to which its regulatory objectives and supervisory principles have been secured, and any other matter the Treasury may direct.[67] A separate report must also be prepared by the non-executive members of the governing board on the discharge of their functions.[68] Further, the Treasury is empowered to commission reviews and inquiries into aspects of the FSA's operations.[69] This has in fact taken place in the form, for example, of the *Penrose Report.*[70]

Another company-like characteristic of the FSA is the annual public meetings it must hold within three months of the report being made to the Treasury.[71] The purpose of the public meeting is to allow general discussion of the contents of the report and provide a reasonable opportunity for the FSA to be questioned as to the manner in which it has discharged or failed to discharge its functions during the period to which the report relates.[72]

The FSA is also accountable to consumers and to the regulated industries in the form of two statutory bodies, the Consumer Panel[73] and a Practitioners Panel.[74] The membership of both Panels is determined by the FSA, although Treasury consent is required for the appointment or removal of the chairmen.[75] The Consumer Panel exists to advise the FSA on the interests and concerns of consumers and to report on the FSA's effectiveness in meeting its consumer protection and public awareness statutory objectives. The Practitioners Panel comprises senior representatives of the businesses that are regulated by the FSA. Both Panels make representations to the FSA and if the FSA disagrees with the view expressed or the proposal made, it must give the panel a statement in writing, and this statement may be made public.[76]

The only explicit mention of 'accountability to Parliament' is the requirement that FSA's report to the Treasury and the reports commissioned under Section 12, should be laid before Parliament, and inquiries commissioned under Section 14 may also be laid. For instance, the FSA *Annual Report* is presented to the Chancellor of the Exchequer, who then puts this report before both Houses of Parliament The lack of formal Parliamentary accountability was debated during the Bill stage of the law. However, the FSMA does not envisage a role for Parliamentary accountability in line with the traditional UK constitutional doctrine of accountability through ministers. In addition, because the FSA is funded by a levy on the financial industry, it is not subject to oversight by the National Audit Office.

Under perceived applicable UK constitutional requirements, the FSA must set up an internal complaints scheme with an independent investigator being responsible for the conduct of investigations.[77] Complaints must be investigated quickly in so far as reasonably

67. *Id.* para 10(1).
68. *Id.* para 10(2).
69. *Id.* §§ 12-18.
70. RH Lord Penrose, Report of the Equitable Life Inquiry (HC 290, Return to an order of the House of Commons, Mar. 8, 2004) (Penrose Report).
71. FSMA sch. 1, para 11(1).
72. *Id.* para. 11(2).
73. *Id.* §. 10.
74. *Id.* § 9.
75. *Id.* §§ 9(3), 10(3).
76. *Id.* § 11.
77. *Id.* sch. 1, para. 7(1).

practicable.[78] Complaints may also be referred to the Financial Services Tribunal or dealt with through legal proceedings at the FSA's discretion.[79]

Finally, the actions of FSA will be subject to *judicial review* to the extent that it is performing a public function under statute. Possible liability may also arise under an action for misfeasance in public office where it can either be established that the FSA has acted with 'targeted malice' or 'untargeted malice' in certain circumstances and loss has arisen.[80]

C. Structure

The structure in which the FSA operates is determined by "principles of good regulation" which are set out in Section 2(3) of the FSMA, and are intended to provide guidance on the way in which the FSA discharges its functions:

- Allocation and deployment of resources should be done in the most efficient and economic way;[81]
- FSA should have regard for the responsibilities of those who manage the affairs of authorised persons;[82]
- Regulation should be proportionate to the benefits that are expected to result from it;[83] and
- FSA should have regard for the desirability of facilitating innovation,[84] the international character of financial services and markets[85] and maintaining the competitive position of the United Kingdom.[86]

The first three principles are based on a *'least-cost'* solution consideration that is becoming increasingly important in the management of regulation. This has been an important condition in financial regulation since the Federal Deposit Insurance Corporation Improvement Act of 1991 was passed in the United States.[87] Provision of public services needs to be carried out based on a 'cost-benefit' analysis, and the cost effectiveness of regulation is an essential factor.

As the regulatory principles indicate, competition has become a prominent consideration in the formulation of financial regulation. The regulatory objective of consumer protection needs to be balanced with the need of the financial services industry to be able to continue to strive in the global context. This is also spurred by the wide-spread belief that the City of London has been able to flourish as a result of its relatively light regulatory burden.

Another structural point to stress is that the new regulatory regime is very much *rule-based*, with the FSA being granted express statutory power to issue rules and guidance under the FSMA (ss 138 and 157). The FSA has used this to produce a substantial *Handbook of*

78. *Id.* para. 7(2).
79. *Id.* para 8(1).
80. *See*, e.g., Three Rivers District Council v. Governor and Company of the Bank of England [2001] UKHL 16. This litigation is still underway at the writing of this article.
81. FSMA § 2(3)(a).
82. *Id.* § 2(3)(b).
83. *Id.* § 2(3)(c).
84. *Id.* § 2(3)(d).
85. *Id.* § 2(3)(e).
86. *Id.* §§ 2(3)(e), (f), (g).
87. Federal Deposit Insurance Corporation Improvement Act, 12 U.S.C.A. § 1823(c)(4) (1991).

Rules and Guidance (*Handbook*) in six major blocks. The main regulatory obligations imposed on firms are not set out in the FSMA directly, but in the separate supporting *Handbook.* This, in particular, includes a separate sourcebook on financial compensation (COMP).[88] From this, we see a major shift in regulatory style as the FSA created a highly legalistic framework within which it operates.

D. Co-ordination with Other Bodies

As already discussed above, the FSA coordinates with various other bodies in order to discharge its functions, such as with the Treasury and the Bank of England and the consultation required with the Consumer Panel and Practitioners Panel. Besides these, the FSA is engaged, statutorily, with the Financial Services Compensation Scheme (FSCS), the Financial Ombudsman Scheme (FOS) and the Financial Services and Markets Tribunal (FSMT). The relationship between the FSA and the FSCS will be discussed more fully below.[89]

In response to the consumer protection objective, the FSA set up the Financial Ombudsman Service Ltd. (FOS) to provide an alternate dispute settlement system for consumers of financial products as means of redress. Various statutory, regulatory, or voluntary ombudsmen were merged to establish FOS. The FOS on the other hand is a statutory institution, which is privately incorporated.[90]

E. Enforcement

The enforcement power of the FSA also constitutes an important element of its structure. Contravention of the regulatory requirements triggers enforcement action by the FSA, which make take the form of disciplinary measures such as public censure or administrative fines,[91] or the FSA may initiate court proceedings leading to injunctions or restitution orders.[92] The FSA can also begin insolvency proceedings against regulated institutions[93] and can prosecute offences under the FSMA and subordinate legislation.[94]

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88. For the full Handbook, see http://www.fsa.gov.uk/handbook.

89. *See infra* Parts IV and V.

90. The accountability of FOS is elaborated in the Memorandum of Understanding (MOU) that was exchanged between the FSA and FOS. According to the FSMA, sch 17, FSA has an obligation to establish a corporate to operate an ombudsman scheme, and to appoint a chairman and a board of directors who are liable to removal by FSA (the Chairman with the approval of Treasury). The terms of their appointment will be determined to maintain their independence from FSA. On the other hand, ombudsmen are appointed by FOS with terms that secure their independence. The funding of FOS comprises of annual fees (or general levy) on firms subject to the FOS's jurisdiction and case fees (users' pay) levied upon the financial institution for each complaint handled by the FOS. This enables the system to be used free by consumers. The FSMT was established by the FSMA to ensure the independence in connection with the conduct of hearings and appeals. The FSMT is independent of the FSA and is administered by the Lord Chancellor's Department. The Lord Chancellor is given power to make rules concerning the conduct of proceedings before the Tribunal, with constitutional and procedural matters being dealt with under the Act. The FSMT has both a first instance and appellate jurisdiction. The function of the FSMT is generally to determine the appropriate action to be taken by the FSA with its decisions being remitted back to the FSA for action. The FSA is required to act in accordance with any determination or direction of the FSMT.

91. *Id.* §§ 205-11.

92. *Id.* §§ 380-86.

93. *Id.* §§ 355-79.

94. *Id.* §§ 397-403.

Concern was given to whether the FSA would be acting as prosecutor, judge and jury in connection with any enforcement action. There was also concern as to whether specific offences such as market abuse and within the disciplinary regime as a whole complied with the European Convention on Human Rights.[95] As such, the FSA was required to establish regular procedures for taking disciplinary action and to act in accordance with them.[96] For example, a clear separation of roles has been instituted within the FSA between those who investigate a case and those who take the decision on potential enforcement action. The Regulatory Decisions Committee (RDC) was established at the initiative of the FSA, although not provided for in the FSMA, to decide on enforcement actions.

IV. Assessment of the FSA Experience to Date

A. Literature Review of the Unified UK-FSA Structure

While various evaluative commentaries have been made regarding the FSA, there is a consensus that the real test will be made when the FSA faces large scale financial distress within the financial system.[97] This section presents some of the comments made to date.[98]

1. *The Enterprise In Itself*

The fact that the FSA created the largest unified regulator in the world, operating with a minimal staff of 2,400 is a regulatory phenomenon to behold.[99] On a superficial level, one could say that what the FSA did was to move the sundry pre-existing bureaucracy to a single premise at Canary Wharf in London. Such a conclusion, while true in part, fails to recognize that the new FSA organization structure is not a mere patchwork but is a genuine and major organizational attempt to assemble and develop an integrated structure. Whether the FSA and the UK government have been successful in achieving this objective remains subject to debate.

2. *Regulatory Costs*

One of the concerns that are especially important in relation to this article is the claim that regulatory cost has increased as a result of the FSA. This is strongly related to the regulatory objectives of the FSA and the evolving regulatory tradition of the FSA. As explained above, the UK financial markets have traditionally relied on self-regulation and *caveat emptor* as a rule. However, the FSA has brought in a new culture of prescriptive regulation and lengthy consultation processes.

The burdensome consultation requirements, the proceduralisation of the FSA's internal operations, by way of detailed and quasi-formal diversification of functions within the or-

95. The European Convention on Human Rights requires that to the extent that proceedings were considered to be criminal in nature, under Article 6, a number of additional safeguards would have to be provided including a clear presumption of innocence and privilege against self-incrimination in disciplinary proceedings. The Article also requires that there is an independent and impartial court and a fair trial with a right to proper legal assistance to the extent necessary. Convention for Protection of Human Rights and Fundamental Freedoms, May 6, 1963.

96. FSMA 2000, *supra* note 40, §§ 395-96.

97. Heidi Mandanis Schooner & Michael Taylor, *United Kingdom and United States Response to the Regulatory Challenges of Modern Financial Markets* 38 Tex. Int'l L.J. 317, 344 (2003). *See also* OECD, *supra* note 29, at 40.

98. *See generally* the FSA Consultation Papers on the Financial Services Scheme.

99. *Cf. Too Big for its Suits?* 361 Economist 8248, Nov. 17, 2001, at 67.

ganisation and the general normalisation of the regulatory process, may actually result in escalating costs, bureaucratic behaviour and a significant reduction of the system's supposedly highly valued flexibility.[100] It is accused of becoming "daily more autocratic, more bureaucratic and costs us more."[101] Moreover, the FSA may prove less effective than anticipated if its very broad scope overloads senior management.[102] Also, a spread of a legalistic culture is taking place as a result of the overwhelmingly comprehensive *Handbook*.[103]

From a U.S. perspective, where a highly legalistic environment has long been in place, this feature of the FSA does not seem terribly disconcerting. However, for the UK, where a "light touch" approach (*i.e.*, use of broad principles and guidances with close, but informal collaboration with the industry) has been the hallmark of the London financial markets, such a shift is not only sudden but is radical.

Compliance costs arising from such a wide ranging regime which covers all firms have also become a potential concern. The Government has tried to put mechanisms in place to constrain these: the FSA is obliged to consider whether the costs of a rule change are proportionate to the expected benefit. It must also consult, by publishing all proposed rule changes for comment.[104] The Chairman of the FSA's Practitioners' Panel comments: "The FSA needs to concentrate on must-dos rather than nice-to-do things. There is an issue about the increased complexity of regulation and costs."[105] The Director of Public Affairs at the Association of Independent Financial Advisers said: "There are too many consultation documents—there are around sixteen on the go at the moment. The industry has not been given the chance to settle down and it seems we are on a treadmill."[106]

There is also rising concern over the increasing regulatory cost of the FSA as fourteen new EU directives are introduced.[107] The Practitioners' Panel said this could "pose a serious threat to the international competitive standing of the UK financial services market."[108] The FSA is credited with doing a reasonable job in keeping on top of the EU financial regulation, but will need to dedicate more resources to cooperate with the Treasury in lobbying Brussels.[109] This increasingly complex supra-environment created by the EU requirements is one aspect that makes the UK-FSA environment different from non-EU countries.

The FSA has further gained greater power with the inclusion of general insurance and mortgages within its ambit of regulation from 2004. This will increase the number of regulated firms from 12,000 to 50,000.

3. *Conflict Between Objectives*

The FSA's principle of regulation is said to be "risk-based" supervision as opposed to "rule-based."[110] But no regulatory authority has yet been able to develop a risk assessment

100. *Tiner's tightrope*, ECONOMIST, Sept. 20, 2003, at 53. *See also* Hadjiemmanuil, *supra* note 30, at 158.

101. Letter from Marie Jennings MBE, Money Management Council. *Letter of Month* MONEY MANAGEMENT. Sept. 2003, at 14.

102. Schooner & Taylor, *supra* note 97, at 344.

103. *Too Big for its Suits?*, *supra* note 99.

104. OECD, *supra* note 29, at 40.

105. Jane Croft, *Restoring Industry's Reputation is Priority*, FIN. TIMES, Apr. 2, 2003.

106. *Id.*

107. *Concerns over Rising Cost of ZNew FSA Regulation*, FIN. TIMES, Mar. 23, 2004.

108. *Id.*

109. Croft, *supra* note 105.

110. *Too Big for its Suits?*, *supra* note 99.

framework that is suitable for assessing the risks in diversified financial conglomerate groups, although this is the focus of a "complex groups" division created within the FSA.[111] This approach is thought by many in the industry to require a "light touch," which may be in conflict with the lengthy consultation process and enormous *Handbook* the FSA has created.[112] While the FSA claims that the "risk-based" approach of supervision enables the FSA to "work with the markets giving consumer protection without disrupting them," this depends on their ability to identify significant risks to the FSA's objectives, which many in the industry are sceptical of.[113]

There is also concern that the enormity of the tasks imposed as a result of the four objectives has led the FSA to near paralysis, with departments working in isolation from each other and employees relying too much on the *Handbook*.[114]

4. *Consumer Protection Concerns*

Some smaller scale pension saving problems have highlighted that an intrinsic difficulty of financial supervision is the trade-off between competition and consumer protection.[115] On the one hand, many in the financial services industry have opposed the FSA's statutory preoccupation with consumer protection as this might obstruct free and fair competition in one of the world's main financial centres.[116] On the other hand, the FSA's complaints commissioner, Rosemary Radcliff, and the Financial Services Consumer Panel have attacked the FSA over its inability to handle consumer problems properly.[117] The Consumers' Association has accused the FSA of being 'detached' from consumer realities.[118] Ron Sandler, who chaired a Treasury sponsored inquiry into the industry in 2002, concluded that consumer rights 'tends to get lost within more mainstream issues.'[119]

In all events, a gap is becoming evident between the FSA's conflicting responsibilities of financial stability, promotion of competition and consumer protection.

5. *Reputational Costs*

The harshest criticism the FSA has received from the Government is seen in the Treasury Select Committee's accusation that the FSA was asleep on the job while recent scandals took place.[120]

Reputation is one of the greatest attributes that a regulatory agency requires in order to operate efficiently in the financial markets. High quality of staff is essential to achieving this goal. However, the FSA's reputation has been tainted by scandals involving its previous chairman, Sir Howard Davies, admitting publicly that the FSA and indigent management have failed.[121] Clearly, the FSA is now seen as susceptible to problems of *reputational con-*

111. Schooner & Taylor, *supra* note 97, at 344.

112. *Too Big for its Suits?*, *supra* note 99, at 67.

113. *Monster Task Baffles Watchdog*, FIN. TIMES, Apr. 19, 2003, at 1.

114. *Id.*

115. OECD, *supra* note 29, at 40.

116. Including Don Cruishank, author of Government commissioned *Competition in the UK Banking: A Report to the Chancellor of the Exchequer* (Mar. 2000). *Headhunting*, ECONOMIST, Dec. 21, 2002, at 106.

117. Sam Dunn, *Money: The Financial Policeman isn't Pulling out the Stops*, INDEPENDENT ON SUNDAY, June 22, 2003, at 12.

118. *Id.*

119. *Monster Task Baffles Watchdog*, *supra* note 120, at 317.

120. *Headhunting*, *supra* note 109, at 114.

121. *Too Big for its Suits?*, *supra* note 103, at 94.

tagion, as regulatory failures, whether apparent or real, undermine its credibility over the broad range of its responsibilities.[122]

As acutely noted by one observer:

> [C]ommentators of the new regime focused upon the importance of maintaining accountability of the regulator. At its most extreme, some critics of the FSA feared that it would become a "behemoth" by virtue of its sheer size and by the breadth of its powers. However the concern was more generally to ensure that its actions could be adequately scrutinised and, if necessary, that the FSA could be called to account. . . . . It will of course take time before it is possible to say how well the FSA has lived up to the hopes and met the concerns of those with an interest in the regulation of financial services. One of the perils of creating a super-regulator is, as the Equitable affair has already taught us, that the more powerful a regulator is perceived to be the more vulnerable it is to criticism when it fails. Furthermore, the broader a regulator's authority, the greater danger there is that failure in one sphere of regulation will undermine confidence in another. The position of the FSA is in some respects akin to a high-wire artist performing without a safety net. It will fail if it does not gauge correctly the proper balance to strike between competing principles, and it will be severely damaged if it misjudges its step, yet it is compelled constantly to move forward.[123]

The main problems in this area for the FSA have come from the retail sector: companies selling services to individuals. The FSA weathered the mis-selling of private pensions, endowment mortgages, the disasters of Equitable Life,[124] and split capital trusts.[125] This brings into question whether the "one-size-fits-all" regulatory policy is appropriate or not.[126] The fact that the FSA regulated advice rather than products leaves it to be reactive as opposed to proactive, trailing along in the wake of events.[127] For example, the recent scandal concerning Equitable Life graphically highlights the inherent policy conflict that may exist between the supervisory and compensative functions within a unified regulator and compensation scheme.

The FSA itself has been self-critical of its role in the Equitable Life debacle, condoning poor communication within the regulator, its staff over-influenced by the confidence of Equitable heads, and a questionable handling of a reinsurance deal that helped Equitable remain solvent.[128] The FSA is now looking into various methods to improve the retail investment sector, and one way is to examine the governance of retail investment funds.[129]

There has also been an incident where the FSA published an open letter to industry chief executives attacking the way they manage their treasury operations.[130] The letter was posted

122. Schooner & Taylor, *supra* note 101, at 317.

123. The Financial Services and Markets Act: A Practical Legal Guide 7-8 (James Perry ed., Sweet & Maxwell 2001).

124. Equitable Life had sold pension policies which it was unable to honor.

125. Split capital trusts are a type of quoted investment vehicles with two or more classes of shares. One class promises high dividends but no guaranteed capital return. Others, known as 'zero dividend preference shares' pay no dividend but promise capital returns on fixed dates. The problem lies in the structure whereby a model was devised that involves buying shares in each other's splits.

126. *Tiner's tightrope*, *supra* note 104, at 53.

127. Kevin Brown, *Why the FSA needs some advice*, Fin. Times, Oct. 4, 2003, at 31.

128. Andrew Bolger and Robert Shrimsley, *FSA 'Self-Critical' of Role in Equitable*, Fin. Times, Oct. 18, 2001, at 1.

129. Sundeep Tucker, *FSA Examines Governance of Retail Investment Fund Sector*, Fin. Times, May 7, 2004.

130. Charles Pretzlik, *Regulator Attacked Over Letter on Website*, Fin. Times, Nov. 13, 2003, at 8.

on the FSA website and reported in the *Financial Times* before many industry chiefs had received it.[131] The Chief Executive of the British Bankers' Association criticised the FSA, stating that several years have been "spent seeking to develop a quality supervisory relationship between banks and the FSA. . . An important element of that relationship is an environment in which banks can feel comfortable being open with the FSA about problems as well as successes."[132] The FSA is also seeking to improve relationships with the fund management industry, which had soured after the split capital trust scandal.[133] In addition, the FSA is working to create more openness of its regulation to boost its somewhat tarnished reputation and bolster transparency of its operations.[134]

6. *Enforcement Power*

The FSA is endowed with a wide range of enforcement powers, in order to encourage the management of financial institutions to take greater responsibility for their actions and face consequences. This has put the FSA "under tremendous political pressure to bring in heads on a plate."[135] The added pressure has led the FSA to fining Lloyds TSB £1.9 million for mis-selling high-income precipice bonds and putting aside £98 million for compensation.[136] Despite being the highest financial penalty yet, it has been generally welcomed in the press.[137] John Tiner, the chief executive of FSA since September 2003, has warned that the FSA would crackdown on products that presented dangers to consumers.[138] This comes in tandem with the problems of the retail sector mentioned above. The FSA has also entered an agreement with the City of London Police Fraud Squad, formalising the police force's powers to arrest people on behalf of the FSA.[139] On the other hand, the FSA has been accused of using "bully-boy tactics" and of making heavy-handed use of publicity.[140] There are also complaints that the enforcement process is opaque and clubbish and that the Regulatory Decisions Committee is not truly independent.[141]

The greater enforcement culture of the FSA, however, has been dragged down by the delays in handling complaints. While the director of enforcement at the FSA wants to cut down the process of enforcement, there is fear that this could lead to further accusations of opaqueness and unfairness.[142] This had lead to the introduction of mediation as well as the involvement of senior management of financial institutions from an earlier stage.[143] The

131. *Id.*

132. *Id.*

133. Simon Targett, *FSA Builds Bridges to Industry: UK's Financial Watchdog Plans New Forum to Mend Relations with Fund Managers*, FT Rep., May 17, 2004.

134. *More Bite Per Bark: a More Open Financial Watchdog Will Have Greater Clout*, Fin. Times, Aug. 4, 2003, at 16.

135. *Too Big for its Suits?*, *supra* note 103, at 94.

136. Kate Burgess, *Lloyds TSB Learns That it Pays to Co-operate: The Bank Has Drawn the Biggest Fine Yet for Mis-Selling in a Clear Sign from the Regulator that it Means Business*, Fin. Times, Sept. 26, 2003, at 4.

137. *Id.*

138. Kate Burgess and Jane Croft, *FSA Chief Warns of Mis-selling Crackdown*, Fin. Times, Sept. 24, 2003, at 2.

139. Kate Burgess, *FSA Set to Flex Muscles on Arrests*, Fin. Times, Aug. 1, 2003, at 1.

140. Kate Burgess, *Enforcer at FSA Aims to Resolve Complaints Much Faster*, Fin. Times, Apr. 3, 2004.

141. *Id.*

142. *Id.*

143. *Id.*

procedural structuring of enforcement is indicative of a broader trend of judicialism of the regulatory process.[144]

B. Assessment of Post-Unification Regulatory Efficiency of the FSA

To assess the regulatory efficiency of the FSA, the following criteria will be used: independence, accountability, transparency, and integrity of the FSA.

1. *Clear Objectives*

The FSA has been given a mandate of four objectives that are clearly stated in the FSMA. Nevertheless, there has been some confusion over the priority of the regulatory objective and principles. This, in turn, has led to confusion over the priorities of the FSA in its regulation.

Foremost, there is still uncertainty of how to balance the objective of promoting competition with that of consumer protection. While the FSA has adopted a risk-based supervision approach to prioritise its operations, it has not resolved the resulting conflicts that occur. This is perhaps due to the fact that risk-based supervision is a complex process and may not be in harmony with the FSA's efficiency principles.

The consumer protection objective tends to be overlooked somewhat by the FSA, which has been a main criticism towards its objectives. This is a challenging objective for a financial market that is accustomed to a light touch style of regulation. However, the scandals that have erupted since the FSA was established have been mainly related to retail products. Thus, the FSA probably will need to rebalance its priorities even more towards consumer protection than it currently tends to.

How the statutory objective of financial stability will be carried out with the Bank of England and Treasury is yet to be seen. There may be some difficulties because the coordination may not be as clear cut as the MOU between the parties envisage.[145]

Furthermore, there is still concern over the cultural divide between the different objectives that the FSA pursues. This may lead to internal turf wars among the different departments of the FSA over the priorities of the organisation and budgetary priorities. This threatens to sacrifice efficiency.

2. *Independence, Accountability, Integrity and Adequate Resources*

The independence of the FSA is somewhat problematic. It does not have a reporting requirement towards Parliament, but rather towards the Treasury. This has been enhanced by the consultation process of regulations, although it has caused a considerable regulatory burden. Nevertheless, the appointment of the Chairman and Chief Executive of the FSA by the Treasury took place in 2003 and was achieved without any apparent problem.

The budget of the FSA is collected by a levy on the regulated industry and is approved by its board.[146] The FSA submits an annual report to Treasury, which lays this before Parliament. The FSA is also accountable to two of its stakeholders, the industry and practitioners, through its Consumer Panel and Practitioners Panel. This ensures that its objectives are adhered to in the context of public institution to the Government, public and regulatees.

144. *See* Hadjiemmanuil, *supra* note 30, at 190.
145. Memorandum of Understanding, *supra* note 53.
146. FSA, 'Governance of the Authority' Board Resolution of 18 March 2004, at p. 4.

In terms of integrity, the FSA staff seems to be sufficiently ingrained by the manner in which the limited number of staff has been overworked. This is also evident from the statement of Sir Howard Davies, the previous Chairman, remarking that bonuses were forfeited due to the management failures involved in Equitable Life.[147]

This leads to the question of adequacy of resources. While the remit of the FSA has grown (whether this is inherent in such a mega-bureaucracy is an open question), the number of staff it hires has not grown proportionately. Though a larger institution may imply greater bureaucracy, without adequate number of staff, the effectiveness of regulation may become compromised.

3. *Transparency*

Transparency of the FSA is ensured by its annual report, annual public meeting, website and consultations. The FSA has been prolific in disseminating information and promoting its principles and objectives.

However, this has had two drawbacks. The industry is overwhelmed by the consultations and may be in a state of over-information. The *Handbook of Rules and Guidance* is an enormous document that is constantly being reviewed. It is becoming difficult to remain up to date on all regulatory matters as well as to grasp the structure of the regulatory framework in light of the prior slate of largely informal regulation.

For consumers, comprehending the regulatory structure of the FSA is not straightforward. While the FSA has published an abundance of information in its website as well as setting up a separate website for consumers, the information is not always clear to lay individuals. This is especially true in relation to understanding the complaints and compensation scheme which has become complex as a result of the unification of the regulator.

4. *Effective Enforcement Powers*

Admittedly, the FSA is endowed with strong enforcement powers and has been using them in the past year or so. This reflects the regulatory philosophy of using greater market discipline by way of making senior management more responsible for their actions. As a result, more fines have been passed out and the FSA will be making arrests to uncooperative regulatees.

This move has been both criticised and complimented by the industry. As the FSA is a powerful institution, its bullying power is quite great even without strong statutory enforcement powers. It is imperative that the FSA balances its enforcement power with support to financial system stability in order to muster the confidence of the industry and public. There have been delays in enforcement due to the number of complaints in the retail sector. This may compromise the effectiveness of timely enforcement.

5. *Comprehensiveness of Regulation*

The ambit of FSA regulation continuously expands with greater specifity. This may be one of the reasons why the FSA has been mired with scandals, especially in the retail sector, due to the lack of expertise and resources in certain areas. The FSA may also require some time to settle into its role and further develop its expertise in the areas it already regulated before its regulatory remit expands.

147. *Too Big for its Suits?*, *supra* note 103, at 67.

6. *Cost-effective Regulation*

The most frequently voiced criticism of the FSA is the increase in regulatory burden resulting from unification. This is not limited to the fees levied for FSA regulation, FOS and FSCS. Due to the *Handbook*, the consultation process is seen as burdensome as well as a prescriptive regulation. The diversification of functions within FSA may have also contributed to a bureaucratic and autocratic behaviour by the FSA. While each consultation incorporates a cost effectiveness consideration, this has not always been effective in stemming the avalanche of regulations taking place.

With London being one of the largest financial centres in the world, the need for clarity in its regulations is essential. However, the resulting product has not always brought this desired effect, but rather, it has produced more confusion due to the complexity of regulations. This may also compromise the competitiveness of the UK's financial markets.

The FSMA and the FSA may have sacrificed one of the greatest traditions of the UK's financial markets by straying from the "light touch" approach to regulation. Whether the toughness of regulation and prescriptive regulation can replace this and maintain the competitiveness of the UK markets is yet to be seen.

One major U.S. investment banker has complained that the costs of regulatory compliance have more than tripled within the past decade in London. An insurance industry leader was exasperatingly critical that all of the Lloyds's syndicates now have to complete a 1,000 page document. In fact, the UK independent think-tank, the Centre for Policy Studies, has compiled a series of over 200 interviews with leading financial industry executives that is replete with a broad range of industry criticism as to the perceived regulatory intrusiveness, marginal competence, inefficiencies, lack of checks and balances, and over-burdensome and costly regulation of the FSA. In fact, these perceptions have become politicised, with the substantial alteration of the current form of the FSA being a primary objective of the Shadow Chancellor's policy agenda.[148]

Further, the UK conservative-based Centre for Policy Studies (CPS) most recently has published a blistering critique of the FSA and its performance to date.[149] The CPS expresses significant concern that the FSA "has lost respect and support of the industry, that competitiveness is being undermined by heavy-handed compliance requirements and that the innovation and entrepreneurialism is being thwarted." Specific concerns of the CPS are:[150]

- the FSA's lack of accountability;
- the FSA is vulnerable to political direction and influence;
- the FSA is an increasingly defensive and risk-averse organization. This is claimed to have contributed to a culture of prescriptive and increasingly complex regulation;
- FSA staff (except those at senior levels) are inward-looking; risk-averse; demoralized by constant change; operate in a blame culture; and "have no positives for success."

The CPS report argues that simply reducing the scope and reach of regulation is not the solution: "Rather, a far deeper response is needed." In particular, the CPS suggests that the

148. *See Letwin Promises Tories Will Abolish FSA*, SUNDAY TELEGRAPH, July 11, 2004, at 1, *available at* www.practiv.com/news/2004/july/news_letwin_promises_tories_abolish-fsa.html.

149. *See* Letter From the Centre for Policy Studies Review Team, The Leviathan is Still at Large: An Open Letter to Mr. John Tiner, Chief Executive of the FSA (Mar. 4, 2004) (*available at* www.cps.org.uk).

150. *Id.*

principal role of the FSA be revised to "foster in partnership with the industry, a healthy, competitive and innovative financial services industry." CPS recommendations include:[151]

- adopting a light touch regime, subject to broad principles in contrast to the current climate of ever-more prescriptive rules, micro-management and combative enforcement;
- revising the FSA's accountability to make it much less dependent on the Treasury, and more accountable to the industry that it serves;
- addressing the ever-increasing indirect costs of regulation and their effects on the competitiveness of the industry both at home and abroad;
- recognizing the skills, sophistication and ability of senior management to manage their own business risks; and removing many of the prescriptive compliance burdens under which they labour;
- clearly differentiating between wholesale and retail market sectors. This will demand functional separations within the regulator of far greater sophistication than at present;
- applying a robust, consistent and proportionate investigation and enforcement regime, concentrated on those senior management failures which put the interest of consumers and the market at risk;
- removing responsibility for consumer education from the FSA's remit; and to assign the responsibility for policing financial crime to the relevant criminal prosecution authorities;
- addressing the FSA's sometimes bureaucratic, defensive and risk-averse behaviour, and developing a culture of partnership with both the industry and consumer groups.

The CPS Report concludes that "the FSA's original aim to be the 'world's best regulator' misses the point."[152]

V. Two Collateral Regulatory Structural Issues of Concern

This Part V will consider two significant collateral issues: (1) unitary versus financial regulation (Part VA); and (2) the handling of the deposit insurance and other compensation schemes (Part VB).

A. The Unitary versus Functional Regulation Issue

While the FSA presents itself as a unitary (mega) structure, to date, the FSA has yet to address adequately the manner in which regulation is to be exercised: that is, *unitary* versus *functional* regulation. This may be because the FSA might consider itself to be a type of functional regulator, in that different departments of the FSA are responsible for monitoring different sectors of the financial industry,[153] or because it considers the British financial regulatory scheme to be a functional system under the "market-failure" definition of func-

151. *Id.*
152. *Id.*
153. Clive Briault, *Revisiting the Case for a Single Financial Regulator*, Feb. 2000, at 18, *available at* http://www.fsa.gov.uk/pubs/occpapers/op16.pdf.

tional regulation.[154] For purposes of this Subsection VA, the unitary regulatory system will be contrasted with that of the sector-based functional regulatory model, with the advantages and disadvantages of each being analyzed. Subsection A1 of this Part V will review the basic arguments; Subsection A2 will discuss the regulatory structure of the FSA; and Subsection A3 will analyze whether the unitary regulator model or the current FSA model is appropriate for emerging market and developing countries.

1. *Review of the Basic Arguments*

One of the primary arguments for the creation of a single regulator stems from the perceived current trend, in major industrialized economies, of the consolidation of all three major financial services, banking, securities, and insurance, within single financial institutions. Proponents of unitary regulation argue that the prudential regulation and supervision of these "financial conglomerates" must be conducted on a consolidated basis.[155] They base this argument on many factors including the possibility that consolidation may artificially inflate a firm's capital base[156] and that risk may become concentrated in a single unit of the conglomerate,[157] which make an overall assessment of the firm's solvency very difficult. They warn that if this task is trusted to multiple regulators, in a functional system, it could lead to the "fragmentation of the supervisory responsibility," which then might lead to an inadequate assessment of the institutions' safety and soundness or an "independent assessment of the overall soundness" by each regulator which could lead to unnecessary costs.[158]

The counterargument to this is that banking, securities, and insurance undertakings retain certain distinctive characteristics and require differentiated policy orientation, regulatory treatment and specialized knowledge. Thus, the "one-size-fits-all" approach to regulation may be inappropriate and even counterproductive, and therefore the functional system may be more desirable.[159] All this being said, the potential problems of fragmented supervisory responsibility and duplicative assessment within a functional scheme remains. In practice, however, these problems can be dealt with by coordination between the different regulators *and* the assignment of a *lead regulator* to a given institution. But, the *lead regulator approach* also has its problems, namely, the possibility that different institutions offering the same products could come under the supervision of different regulators and

154. In "market failure" functional regulation, one regulator is assigned to correct each of the four primary sources of market failure. A prudential regulator deals with information asymmetry, the conduct of market regulator deals with market misconduct, another regulator (ideally a central bank) deals with systematic instability, and a fourth has jurisdiction over anti-competitive behavior. This model has only been adopted in its pure form in Australia, but the UK has adopted a version of it in which prudential and conduct of market regulation are carried out by the same regulator (the FSA). Such a system has been criticized by some commentators who believe that there is no reason to combine prudential and conduct of market regulation and that doing so leads to confusion and inefficiency due to the fact that the objectives of the two types of regulation often conflict. The FSA has recently added to its list of objectives the encouragement of competition in the financial services industry which arguably extends its jurisdiction over another source of market failure, anti-competitive behavior.

155. Richard Dale & Simon Wolfe, *The Structure of Financial Regulation*, 6 J. FIN. REG. COMPL. 326, 337-39 (1998).

156. Jose de Luna Martinez & Thomas A. Rose, *International Survey of Integrated Supervision*, Jul. 31, 2003, at 2, *available at* http://econ.worldbank.org/files/28404-wps3096.pdf.

157. *Id.*

158. Hadjiemmanuil, *supra* note 30, at 132.

159. *Id.* at 142.

thus subject them to inconsistent rules, standards, and enforcement practices. This, in turn, could lead to institutions attempting to change their classification to come under the jurisdiction of the lead regulator whose standards are the most lax or whose supervisory practices are the least intrusive.[160] This result was one of the problems associated with the institutional system of regulation, but there is a possibility that improved coordination between the different regulators might nullify it.[161] Even if this is not the case, some commentators have pointed out that this phenomenon, know as "regulatory arbitrage," is not necessarily detrimental to the financial industry.[162] For example, the Chairman of the Federal Reserve Board, Alan Greenspan, cites the fact that important market innovations have come about as a result of regulatory arbitrage, and that a single regulator could hinder such innovation.[163]

Another argument in favour of a unitary over functional regulation is that "financial engineering" has lead to the development of products that do not fit neatly into any of the three functional categories.[164] This could lead to jurisdictional uncertainty that could result in either regulatory duplication or the product in question simply slipping through the regulatory cracks.[165] One of the most cited examples of such a product is the credit derivative.[166] It could be argued that credit derivatives are banking products in that they are primarily used by banks as risk management tools.[167] However, they may also fall under the definition of a security in certain jurisdictions,[168] and they could also be considered insurance products.[169] This product not only falls into different functional categories, which could lead to jurisdictional confusion, the size of the credit derivatives market, as of 2004, was $800 billion dollars, growing at a projected rate of 100 percent per year.[170] Is it really likely that a product such as this would simply slip through the regulatory cracks, especially after the LTCM debacle? And, even if there is a possibility of duplicative supervision and regulation, are multiple regulators monitoring such a dynamic market, whose sheer size could pose grave systematic risks, actually regulatory detrimental or undesirable. It is also not apparent that much duplication has taken place in functional jurisdictions such as the United States where the banking regulators monitor the prudential aspects of credit derivatives such as risk management and capital adequacy,[171] and the SEC and CFTC have jurisdiction over any market makers of the products.[172] While it is indeed possible that other hybrid financial products that may not attract much attention as credit derivatives could slip through the cracks or be subjected to duplicative and possibly contradictory regulation,

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160. *Id.*

161. Abrams & Taylor, *supra* note 17.

162. Hadjiemmanuil, *supra* note 30, at 140.

163. Alan Greenspan, Remarks at the Annual Convention of the Independent Bankers Association of America (Mar. 22, 1997), *available at* http://www.federalreserve.gov/boarddocs/speeches/1997/19970322.htm.

164. Abrams & Taylor, *supra* note 17.

165. Hadjiemmanuil, *supra* note 30, at 175.

166. Schooner & Taylor, *supra* note 97, at 322.

167. Andree Scheerer, *Credit Derivatives: An Overview of Regulatory Initiatives in the U.S. and Europe*, 5 FORDHAM J. CORP. & FIN. L. 149, 153 (2000).

168. A call option on a bond, which is an embedded credit derivative is a security under the U.S. 1933 Securities Act and the 1934 Securities Exchange Act.

169. Bruce E. Kayle, *The Federal Tax Treatment of Credit Derivatives*, 638 PLI/TAX 173, 179 (2004).

170. *Id.* at 177.

171. Desmond Eppel, *Risky Business: Responding to OTC Derivatives Crisis*, 40 COLUM. J. TRANSNAT'L L. 677, 680 (2002).

172. *Id.* at 701.

there is no reason to believe that improved coordination between regulators could not solve this problem.[173]

Another main argument for a unitary regulator is that such a system will achieve significant economies of scale and scope, which could otherwise not be achieved in a functional system. However, there is an absence of hard data to support the economies of scale argument based on the experiences of the nineteen countries that have adopted a unitary regulator.[174] As for the economies of scope argument, their experiences suggest that the internal organization of these regulators has tended to mirror traditional institutional lines.[175] Whether such a system, which basically places the different functional regulators under the same roof, contributes to greater efficiency is yet to be seen.

While the validity of the alleged benefits of a system of unitary regulation is somewhat questionable, the dangers of such a system are clear. The unitary regulator may not have clearly defined objectives or conflicting objectives such as the inherent conflicts between conduct of market and prudential regulation.[176] This situation could lead to a loss of accountability, as there would be no single standard of performance, and confusion on the part of the regulator, when the objectives do conflict, which could result in ineffective supervision.[177] The lack of clear objectives could also lead to what some commentators have termed "mission creep" in which the regulator becomes responsible for more activities than was the original intention and which results in it becoming an unwieldy bureaucratic entity that loses both focus and efficiency.[178] Another potential danger of a unitary system is increased *moral hazard.* Some commentators have expressed fears that creditors of non-bank financial institutions may come to believe that their exposures to non-bank financial institutions are covered by state guarantees, as is the case with the liabilities of the banking sector, leading them to make imprudent credit extension decisions.[179]

> More importantly though, financial institutions and investors could come to believe that the industry as a whole is in good hands simply because of the existence of a mega regulator. Investors as a result may not keep up there end of the bargain by not watching where they are putting their money and how it is performing, and managers at financial institutions may also relax their own prudential risk assessment due to this false sense of security.[180]

Another danger of regulatory amalgamation is the increased threat of cross-sector contagion resulting from credibility contagion. This could occur if one sector experienced a regulatory failure or scandal (such as Equitable Life in the UK) thus causing the public to believe that the other two sectors were not effectively regulated.[181] Perhaps the most acute danger of the unitary regulator model results in "group-think" by focusing the majority of its attention and allocation of resources on one institution or business it believes poses the greatest systematic risk to the financial system. "Group-think" will cause the regulator to

173. Martinez & Rose, *supra* note 156.

174. *Id.*

175. Abrams & Taylor, *supra* note 17.

176. Taylor, *Twin Peaks*, *supra* note 14, at 2.

177. Hadjiemmanuil, *supra* note 30, at 143.

178. Canada Deposit Insurance Corporation, *Amalgamation and the "Super Regulator": Rationale and International Examples* (2004).

179. *Id.*

180. *Id.*

181. *Id.*

ignore other institutions or businesses who current less apparent risks that could come to fruition if left unchecked.

These six risks are arguably less of a danger or even non-existent with functional regulation. Specialized regulators generally have clearly defined, non-conflicting objectives.[182] As for moral hazard concerns, the functional system reduces the potential confusion about where public safety nets end. This reduction mitigates the risk that creditors of a non-bank financial institution might mistakenly believe that their exposures are covered by state guarantees, and the risk that the existence of a mega-regulator in and of itself will create a false sense of security is also obviously not present.

There is also less of a risk of cross-sector contagion resulting from credibility contagion. A failure by one sector's regulator will not necessarily undermine the public's confidence in the regulators of the other two sectors. The fact that different regulators are concentrating their efforts on different sectors of the financial industry, in a functional system, substantially reduces the possibility that certain institutions and businesses will not be sufficiently monitored or even ignored which could occur if a unitary model if the sole regulator engages in "group-think." In addition to mitigating or eliminating the aforementioned risks associated with the unitary system, a functional regulatory scheme may also be superior to the unitary system because a greater safety and soundness may be achieved through multiple regulators supervising a given institution for the simple reason that three regulators are less likely than one to overlook a potential or existing threat to the financial system. Also, especially focused and committed regulators may help a particular financial industry develop more competitively.

2. *The FSA Model*

The UK seems to have adopted a hybrid approach to financial market regulation. Other countries with mega-regulators have attempted to consolidate supervision by creating common standards that apply to all types of institutions and activities.[183] Yet the FSA (notwithstanding developing a comprehensive *Handbook*, which is more a compendium than a set of unitary rules) has adopted different prudential standards for each different type of institution and different business conduct rules for each business activity.[184] Also, the internal structure of the FSA also apparently mirrors traditional sector boundaries.[185] Thus, it could be argued that the FSA is not a true mega-regulator, but rather an "umbrella" organization under which the three functional regulators operate. This arrangement seems to nullify many of the advantages of a unitary regulator because different regulators and different sets of standards would supervise the financial conglomerates. This could lead to the same problems that are inherent in the functional system including regulatory overlap, conflicting rules, and the possibility that an institution or financial product could slip through the regulatory cracks. Some commentators have pointed out that an umbrella regulator may not be very effective in resolving such problems if there is communication and coordination problems among its subgroups.[186]

182. Abrams & Taylor, *supra* note 17.

183. Martinez & Rose, *supra* note 156, at 19.

184. FIN. SERVS. AUTH., THE FSA ONLINE HANDBOOK, *at* http://fsahandbook.info/FSA/handbook.jsp (Mar. 28, 2005).

185. Briault, *supra* note 153.

186. Clive Briault, *The Rationale for a Single National Financial Services Regulator*, FSA OCCASIONAL PAPER SERIES (Fin Servs. Auth., London), May 1999 at 19, *available at* http://www.fsa.gov.uk/pubs/occpapers/OP02.pdf.

In response to these criticisms, the FSA has hypothesized that communication and coordination issues are less problematic under an umbrella regulator than under a functional regulation scheme because separate regulators have different cultures and decision-making structures.[187] The obvious problem with this argument is the lack of guarantee that this will not occur in an umbrella regulator, in that its employees will presumably come from regulatory organizations with different cultures and decision-making structures. Further, as long as they operate in relative isolation within different divisions of the FSA, there is no guarantee that these differences will go away. The FSA seems to believe that common management can successfully do away with these problems,[188] but the belief that common management fosters better communication and information-sharing has recently come into question with the FSA's mishandling of the Equitable Life debacle. Indeed one of the primary reasons cited for the Authority's regulatory failure was poor internal communication.[189]

The FSA may have answered many of the critics of the umbrella regulatory model with the creation of the "complex groups division," which specializes in the supervision of financial conglomerates.[190] This division/group will presumably pool together banking, securities, and insurance regulators and receive and coordinate information from the different subgroups of the Authority in order to better supervise multi-sector financial institutions. According to one prominent FSA official, the group will in fact act as a lead regulator.[191] This seems rather odd because the FSA originally seemed to imply that bringing all of the regulatory bodies under one roof would solve many of the communication and coordination problems associated with functional regulatory systems which often utilize lead regulators.[192] If this is the case, one might question why a lead regulator is necessary in such a unitary system.

The creation of this new FSA group also raises further questions. For instance, are coordination and communication likely to be less problematic with four regulatory groups supervising a conglomerate rather than three? In other words, will the addition of the fourth group solve the problems associated with the functional system, such as duplicative and conflicting standards and turf wars, or will it be an additional source of such problems?

Furthermore, the creation of a mega-regulator is supposed to simplify the supervisory and regulatory process[193] and to generate economies of scale and scope that will result in significant cost savings.[194] One might question how the addition of a fourth regulatory group, which shares jurisdiction over institutions with up to three other regulatory groups, could lead to either greater simplicity or cost savings. The premise that a system where three different regulatory agencies are placed under the same roof, with a fourth added to coordinate their activities, is somehow superior in terms of both efficiency and effectiveness to a lead-regulator functional system is not very compelling and appears to be not well-thought out by the policy-makers.

187. *Id.*

188. *Id.*

189. Tucker, *supra* note 129.

190. Abrams & Taylor, *supra* note 17.

191. Rosemary Hilary, Remarks to the Association of Chartered Certified Accountants (May 1997), *available at* http: www.accaglobal.com/publications/fsr/51/23178.

192. Briault, *supra* note 186, at 19.

193. Hadjiemmanuil, *supra* note 30.

194. *Id.*

Even if the different regulatory groups within the FSA are able to coordinate their activities so that they can act in a consistent and coherent manner as a single regulator, this may not be beneficial for the financial services industry. One regulatory body will be in charge of both market conduct and prudential regulation. Many commentators have argued against the creation of such a system because the objectives and instrumentalities of the two types of regulation are very different and their objectives often conflict.[195]

As mentioned earlier, other commentators have noticed that placing responsibility for statutory/regulatory objectives which have the tendency to conflict within the jurisdiction of one regulator can lead to a loss of accountability, confusion when the objectives do conflict, and decreased transparency.[196] The FSA's answer to this is that prudential and conduct of market regulation are really not all that different because ensuring that the senior management of a given firm has established adequate internal controls and an adequate compliance culture is the basis of both types of regulation.[197] This contention completely misses the point. Even if controls are in place to prevent an institution from engaging in market misconduct, there is obviously no guarantee that it will not do so. What if a bank, in the course of carrying out securities activities, engages in some sort of market abuse? What is the regulator to do? Should it harshly punish the bank to discourage future transgressions, even though such an action could jeopardize the institution's safety and soundness, or should it treat the matter with leniency, to protect the institution, and risk sending the message to other financial institutions that the consequences of such actions will not be so severe as to endanger the financial well being of an institution that engages in them? The FSA does not deal directly with this particular issue. It does however acknowledge that conflicts between regulatory objectives will arise from time to time and are better dealt with inside one agency rather than between multiple agencies.[198] The FSA's only rationalization for this theory is that one agency would be able to handle the matter in a more efficient manner than the alternative. Yet once again, this rationalization is based on the questionable assertion that they will be more efficient than a multi-regulator functional system.[199]

In addition to this conflicting objectives conundrum, the FSA could face many other problems from the creation of a mega-regulator. Among these are increased moral hazard, credibility contagion, and "mission creep."[200] As for the latter, it could be argued that the FSA has already started down this path because it has jurisdiction over mortgages and encourages competition within the financial industry, two objectives that were not part of its original mandate.[201]

The FSA's regulatory approach may have at least one advantage over that of the mega-regulator though. This advantage stems from the fact that its internal structure mirrors traditional institutional lines.[202] If the FSA's sector-based groups, acting beneath the regulatory umbrella, continue to maintain some form of independence from one another, then

195. Taylor, *Twin Peaks*, *supra* note 14.
196. Hadjiemmanuil, *supra* note 30.
197. Briault, *supra* note 186, at 24.
198. *Id.* at 21.
199. *Id.*
200. *Id.* at 26, 30, 33.
201. CDIC, *supra* note 178.
202. Briault, *supra* note 153, at 8.

a regulatory scheme where multiple eyes watch the financial industry could result, as in the case of a completely integrated mega-regulator. One might assume that such a system, in addition to providing better supervision than that of a mega-regulator, would also prevent the organization from engaging in "group think," the most perilous of all of the risks associated with the creation of a mega-regulator. According to the FSA though, this will unfortunately not be the case. They have stated that "one crucial element . . . is the development of a single system of risk-based supervision under which regulatory resources are devoted to those firms and those areas of business that pose the greatest risk."[203] Thus they are not attempting to mitigate this risk, but instead are embracing it as a policy goal.

3. *The Unitary and the FSA Model in Emerging Markets*

Many of the proponents of unitary regulation believe that this model is ideal for emerging markets.[204] They believe that

> [R]egulatory flexibility is very important in the context of emerging markets because countries which have recently liberalized often experience a process of rapid industry change, which may include the growth of certain non-bank intermediaries which can pose a significant threat to financial sector soundness. Thus having one regulatory agency with the scope and capacity to respond rapidly to these changes by extending its regulatory jurisdiction is a major benefit of a properly constituted regulatory agency.[205]

The opponents of the unitary system will inevitably argue that this objective could be achieved by improved coordination and communication between regulators. However, this approach was attempted in Mexico and was apparently unsuccessful, since the securities and banking regulators were subsequently merged.[206] The proponents of the unitary system also argue that the economies of scale and scope realized from establishing a mega-regulator could result in the more efficient use of resources such as capital, manpower, and management talent, which are relatively scarce in many emerging economies.[207]

While these two arguments seem convincing, there are substantial problems with both of them. First of all, in order to achieve significant economies of scale and scope within a system of unitary regulation, there must be a true consolidation of all regulatory functions rather than a system where the three different regulators are housed under the same roof.[208] This has not been the case with many of the countries that have adopted the unitary approach.[209] While many of these countries have claimed to achieve significant consolidation of banking and securities regulation, they have not been very successful in consolidating banking and insurance regulation, and there is apparently little hope for achieving further consolidation in the future.[210] This raises the question as to whether an emerging market country should be expending its time and limited resources attempting to develop a consolidated approach, especially in light of the fact that there is very little guidance from the international community on how to achieve such an approach.[211]

203. *Id.* at 20.
204. Abrams & Taylor, *supra* note 17.
205. *Id.*
206. Martinez & Rose, *supra* note 156, at 19.
207. Abrams & Taylor, *supra* note 17.
208. *Id.*
209. Martinez & Rose, *supra* note 156, at 9.
210. *Id.*
211. Abrams & Taylor, *supra* note 17.

There are also problems with the argument that the creation of a unitary regulator provides the highest degree of regulatory flexibility to adapt to the dynamic changes that occur in the financial sector of an emerging market country. For one, some commentators think that the exact opposite is true. They believe that establishing a single supervisory body eliminates the system of checks and balances in functional regulation and could result in a bureaucratic entity unable to rapidly respond to market developments.[212] Even if a single regulator can more rapidly adapt to market developments, for this to occur, the enabling statute must be drafted with sufficient flexibility to permit the regulator to rapidly respond to market innovations.[213] The possibility that poor drafting could undermine the effectiveness of a unitary regulation regime is a risk in any country, but it could be argued that this problem is especially predominant in an emerging market country where the legislators and policy makers may be less sophisticated and have less experience dealing with financial regulation than there colleagues in developed countries. Once again, there is also very little guidance from the international community on how to draft such a statute.[214]

In addition to the somewhat questionable justifications for the establishment of a unitary regulator in emerging market countries, there are reasons why such an approach may be completely inappropriate in such a country. For one, there may be no need for the establishment of a single regulator in an emerging economy with an underdeveloped banking system and a capital market in its infancy. In such countries, there is generally little or no link between the two markets, and because the primary motivation for regulatory amalgamation is the emergence of financial conglomerates.[215] the creation of a unitary regulator in this context would make very little sense. In addition, the creation of a unitary regulatory regime requires the amendment of a significant amount of legislation.[216] With this come certain transitional risks such as the possibility that powerful special interests and political and bureaucratic actors could capture the regime and weaken the regulatory framework to a level below that which was in place before.[217] While this is a problem in developed countries as well, this problem may be even more predominate in an emerging market country where the policy-making process may be less transparent and thus more susceptible to regulatory capture.

The FSA model may also be inappropriate in emerging markets for many of the same reasons. For one, its creation did require the amendment of a significant amount of legislation.[218] Thus, if such a model were to be implemented in an emerging market country, there would be the risk of regulatory capture and a weakening of the existing regulatory framework. The FSA is also an umbrella organization with different regulators housed under the same roof,[219] so the efficiency generated by economies of scale and scope would be probably be limited.[220] An FSA model also may not be ideal in a country with an underdeveloped securities market and a banking system that is not closely linked to that mar-

212. Martinez & Rose, *supra* note 156.
213. Abrams & Taylor, *supra* note 17.
214. *Id.*
215. Martinez & Rose, *supra* note 156.
216. *Id.*
217. *Id.*
218. *See* Financial Services and Markets Act 2000, c. 8 (Eng.).
219. Briault, *supra* note 153.
220. Hadjiemmanuil, *supra* note 30.

ket. Finally, just as it may not appropriate for an emerging market country to dedicate its scarce resources to the development of a consolidated supervisory system, as is the case with the creation of a unitary regulator, it also may not be appropriate for such a country to devote its resources to the creation of an FSA-like entity that would require the country to deal not only with the logistics of bringing existing sector regulators underneath one umbrella organization, but also with the creation of a fourth regulator to coordinate the activities of the other three.

B. Interfacing with a Modern Deposit Insurance Scheme.

In the Parliamentary and Governmental discussions leading up to the passage of the FSMA and its subsequent implementation, sparse attention was given to how the UK deposit insurer, the umbrella Financial Services Compensation Scheme ("FSCS"), would fit into and contribute to the mega-regulatory structure set-up. This was probably due to the fact that the UK has traditionally viewed compensation schemes as marginal arrangements that are not critical to ensuring safety and soundness, financial stability and market integrity.

1. *General Considerations*

The UK approach essentially has been a limited "pay-box" type of mechanism, while the modern international approach/trend favoured by countries such as the United States and Canada, by the IFIs (*e.g.*, the IMF) and by the international "standard-setter" in the deposit insurer area (*i.e.*, the IADI, in conjunction with the FSF) is for an insurer with more comprehensive functions linked to crises resolution and financial stability. This insurer is also separate and independent from the bank/financial institution regulator/supervisor. If a government desires this latter modern approach for its deposit insurer, then such policy issues as to whether it is best to have the insurer tied-up into a consolidated framework, including being controlled by the supervisor (with all the inherent potential conflicts of policies/interest that might arise), need to be sorted out clearly and carefully *ex ante.*[221]

Generally, the fundamental policy choice to be made is between two different types of deposit insurers, namely: (1) a 'modern' scheme which is designed to play an active part in crisis management and perhaps even in the on-going prudential supervision of banks and other financial institutions; and (2) 'weak' or mere 'paybox' model whose function is reduced to providing minimum compensation upon the insolvency of insured firms. It would appear that this question has manifold implications with regard to, *inter alia*: (1) the costs of deposit insurance to insured firms and the general public; (2) the level of coverage offered; (3) the incentives generated on both insured firms and the investing public, and thus, not least; (4) the overall efficacy of prudential regulation in the broad sense; and (5) the fostering of sector and systemic financial stability.

As discussed below, a 'modern' scheme will often exist where, as a reaction to political pressure or for other reasons, the required level of coverage is high. In such a case, the readiness of participating firms to contribute fees will often be procured on a strict *quid pro quo* basis, *i.e.*, only if the participating firms are granted strict control over both the risk incurred by the scheme and the use of funds in crisis. Such a system may appear particularly attractive in rather stable market environments which are dominated by a small, rather

221. *See* discussion on Subsection VB2 below.

homogeneous group of institutions with broadly homogeneous commercial interests, between whom agreement is easily reached.

A strong scheme also may play an active role in the overall framework for prudential regulation if it subjects its member institutions to intensive on-going screening in accordance with strict entry criteria. It will frequently choose to do so to keep the risk of loss small and thus acceptable to participating institutions. Moreover, in appropriate circumstances, it may also have an important role to play in crisis management, *e.g.*, as a vehicle for market-based rescue operations. A downside, however, might be found in the potential of such systems for anti-competitive behaviour; in particular, where the system is effectively controlled by a small group of institutions in a highly competitive market environment.

A strong scheme with generous levels of protection can be criticized as reducing the incentives for depositors and investors to critically assess and monitor the participants' performance. As such, in structuring such models, special care needs to be taken in order to offset such consequences with restrictive entry criteria and the ongoing supervision of participants. Arguably, agreement on these issues should be rather easily reached (in particular where the financing of the scheme takes place on an *ex ante* basis), since this reduces the risk of loss to the fund and thus to all members. A good example for both the advantages and the disadvantages of 'strong' models may be found in the German Deposit Insurance Fund which has been set up by the Private Bankers' Association without any formal (in the sense of statutory) framework.[222]

A 'weak' system, by contrast, may fare well in a heterogeneous market environment with numerous disparate interests. While such a system helps avoid the anti-competitive effects frequently generated by strong schemes, the benefits associated with strong schemes in terms of increased financial stability will be difficult, if not impossible, to reach if a system operates merely as a 'paybox'.[223]

2. *Determining the Role of a Deposit Insurance Scheme*

A basic inquiry relates to the role the deposit protection scheme should play in a country's financial safety net. Specifically, should its mandate be confined as much as possible to that of a "pay-box," like with the FSCS, in which the deposit insurance provider merely reimburses the depositors of failed institutions, or should it act as a risk-minimizer, as is the case with the FDIC and the CDIC, by taking on a proactive role in protecting itself from losses that might result from excessively-large payouts to the depositors of covered institutions? The primary benefit of the "pay-box" system, other than simplicity, is that its administrative costs are much lower than that of a deposit insurer with a risk-minimization mandate. In addition to this benefit, a deposit insurer with a "pay-box" mandate would typically not have the intervention powers that a deposit insurer with a risk-minimization mandate would. Thus, the possibility of the insurer acting in an inconsistent or duplicative manner

222. J.H. Binder, *supra* note 10.

223. For further consideration of what is internationally desirable as to a modern deposit insurer, *see, e.g.*, Stefan Ingves (Director, Monetary and Financial Systems Department, International Monetary Fund), *Strengthening Governance Arrangements for Financial Sector Oversight Agencies: Evidence from the FSAPs*, APEC Policy Dialogue on Deposit Insurance, Kuala Lumpur, Malaysia (Feb. 16-18, 2004); *APEC Policy Dialogue on Deposit Insurance: Policy Conclusion Paper* (rev. draft of June 15, 2004). *See also*, Financial Stability Forum, *Guidance for Developing Effective Deposit Insurance Systems* (Sept. 2001); and various relevant materials and data on deposit insurances as presented by the IADI, *available at* http://www.iadi.org/html/ (last visited Apr. 11, 2005).

with that of the country's prudential regulator is all but non-existent under the "pay-box" scheme.[224]

Despite these advantages, the one big disadvantage with the "pay-box" scheme is that the insurer has very little ability to shield itself from large-scale losses associated with reimbursing the depositors of multiple failed institutions. This became painfully obvious in Canada between 1967 and 1987 when the CDIC, acting as a "pay-box" insurer, was losing a staggering average of fifty-three cents on the dollar for each payout.[225] The U.S. FDIC had a very similar experience to that of the CDIC between the years 1975 and 1994. Despite the fact that it was often able to utilize purchase and assumption transactions to prevent it from having to make payouts, the payouts that it did have to make added up to $99,945,147, a figure which included an alarming $36,428,629 in losses. As a result of these losses, reforms were made to both the CDIC and the FDIC to allow them to better mitigate the risk of large-scale financial loss.[226]

The CDIC, under its risk-minimization mandate, has been given the power to control the entry and exit of member institutions, to establish the conditions of insurance and to monitor the member banks' compliance with those conditions, and to take enforcement action where necessary.[227] The FDIC also has broad powers to control the entry and exit of banks from the insurance scheme,[228] to establish conditions for continued coverage, such as capital adequacy and sound management,[229] to monitor and investigate institutions for compliance,[230] and to take enforcement action where necessary.[231] In addition, the FDIC also has approval powers, in some cases, over actions by member banks that could affect their solvency. This includes mergers, changes in control, and the retirement of capital stock of capital debt instruments.[232] In light of its past large-scale losses, the FDIC also was given the power to act as a receiver in bankruptcy proceedings, which allows it to file suit against officers and directors of failed banks to recover any lost funds.[233]

While the risk-minimization mandate can definitely help shield a deposit insurer from the risk of loss, this is not the only benefit of such a system. For instance, the costs associated with a loss by a deposit insurer are presumably passed on to either the financial system in terms of higher premiums or to the tax-payer, so the mandate helps to shield both of those groups from losses as well. More importantly, the deposit insurer, in taking on a risk-minimization role, can actively promote standards of sound business and financial practices for member institutions through regulation, supervision, and enforcement, which allows it to contribute to the stability of the financial system.[234]

While the arguments in favor of a deposit insurer with a risk-minimization mandate (*i.e.*, a 'modern' system) seem to far outweigh those against it, there is still the possible problem

224. *See* Canada Deposit Insurance Corporation, CDIC's Mandate, Independent States and Role in Canada's Financial Safety Net (2003).

225. *Id.*

226. Schooner & Taylor, *supra* note 101, at 618.

227. CDIC, *supra* note 178.

228. 12 C.F.R. §§ 303.24, 308.120.

229. 12 C.F.R. § 325.3.

230. 12 C.F.R. § 308.144.

231. 12 C.F.R. § 325.4.

232. 12 C.F.R. §§ 303.62, 303.82, and 325.3.

233. Schooner & Taylor, *supra* note 101, at 637.

234. CDIC, *supra* note 224.

of regulatory inefficiency, which could result from the deposit insurer's prudential rules conflicting with those of the regulator or supervisor, and the problem of the two entities disagreeing over whether to declare a bank insolvent and to close it. Stephan Ingves, the Director of the Monetary and Financial System Department of the IMF, believes that the problem of regulatory inefficiency and potential conflict arising over bank closure policies can be dealt with by establishing a clear mandate for each institution involved in the financial safety net and by establishing effective coordination and cooperation schemes between those institutions.[235] This is how the FDIC and the two other primary banking regulators of the United States, the Federal Reserve Board and the Comptroller of the Currency, have dealt with this problem. The three entities work together to develop common rules and standards to achieve regulatory consistency, primarily through the issuance of joint interagency statements.[236] As for the problem of inconsistent bank closure policies, the FDIC's mandate is quite limited. It would not for instance be able to close a national bank;[237] this decision would be made by the Comptroller of the Currency (OCC) who would then appoint the FDIC as the receiver.[238] The reality would be that the FDIC and OCC would be in consultation once the bank was determined to be in a troubled condition pursuant to the regulations. This provided a prompt corrective action mandate under the 1990 Federal Deposit Insurance Corporation Act (FDICM) legislation.[239]

3. *The Question of Independence*

A further inquiry is whether the deposit insurer should be *independent* of the government and of the regulator/supervisor. As to independence from the government, the Monetary and Financial Systems Department of the IMF has taken the view that agencies involved in the financial safety net of a country should be independent of the government, in that they should have *operational independence* in using the instruments and means assigned to them, because this allows them to fulfil their mandates in the most effective and efficient manner.[240] The Fund puts forth multiple rationales for this proposition. One reason given is that independence helps to shield the agencies from any excessive political or industry interference that could hinder or otherwise frustrate their activities.[241] This phenomenon occurs for a number of reasons, one of which being that if agency personnel feel that they are truly independent, they will be less likely to yield to outside interference. Independence could also lend credibility to the agencies by reducing or eliminating any suspicion on the part of the public or the regulated institutions that the agency activities are influenced by political considerations. Obviously if such a suspicion did exist, this could compromise the agencies' credibility and thus undermine their effectiveness. The IMF also points out that independence of the agencies from the government in the financial safety net is also helpful in reducing some sources of conflicts of interest.[242]

235. Ingves, *supra* note 223.

236. *See, e.g.*, Interagency Statement on Retail Sales of Nondeposit Investment Products, *available at* http://www.fdic.gov/regulations/laws/rules/5000-4500.html (last visited Apr. 12, 2005).

237. *See* John L. Douglas, *Financial Institutions: Regulation and Legal Challenges in the 1990s*, 27 WAKE FOREST L. REV. 11 (1992).

238. 12 U.S.C. § 91.

239. *See, e.g.*, J. NORTON AND S. WHITLEY, BANKING LAW MANUAL (1995).

240. Ingves, *supra* note 223.

241. *Id.*

242. *Id.*

While the problem remains that an independent agency may be less accountable to the public and the institutions they regulate because they are not directly controlled by the government and often do not have to answer directly to their country's legislative bodies, the IMF points out that a very high level of accountability can be achieved through increased transparency. They do however caution that while accountability of these agencies is important, the government should extend legal protection to agency employees for all good faith actions taken in the course of their duties. Without such indemnity, their ability to properly execute their duties becomes very limited. The IMF indicates that it has witnessed scenarios like this in several countries, and that "in the end, such situations contribute to financial instability."[243]

As to whether the deposit insurance provider should be independent of the regulator/supervisor, it should be noted that in the majority of jurisdictions, the insurer is independent of the regulatory and supervisory body, particularly in developed financial systems.[244] However, the FSCS, the British deposit insurance provider, has been set up as a direct subsidiary of the regulator/supervisor, the FSA.

Despite possible advantages of having the insurer subordinated to the regulator,[245] the United States and Canada have both opted to preserve the separation of their deposit insurance schemes and regulatory/supervisory bodies. The Policy and International Department of the Corporate Affairs Division of the CDIC has explained their rationale for maintaining the separation in a recent policy paper.[246] The CDIC's first argument could be best characterized as a "two heads are better than one" rationale.[247] It believes that "judgments on how to deal with distressed or failed financial institutions not only have a substantial impact on the cost of deposit insurance to the financial system but also have wide implications for the stability, competitiveness, and characteristics of the financial system."[248] "Thus the judgments arrived at and the decisions made, on average are likely to be better, and to be more acceptable, if they reflect two independent assessments rather than one."[249] The CDIC's next justification revolves around potential abuses of power in which an entity that insures depositors and regulates and supervises financial institutions might engage.[250] It points out, as an example, that a regulator/supervisor, with the ability to charge institutions premiums for deposit insurance, might use those premiums as a tax to cover its own costs that might accrue as a result of its mishandling of a distressed firm.[251] The CDIC also fears that a deposit insurer with unchecked regulatory powers might suffocate the financial system with excessively burdensome restrictions, and premature closures, in pursuing its mandate of protecting depositors and protecting itself from loss.[252] It believes that "a better

243. *Id.*

244. IADI website, *supra* note 1.

245. For example, arguably, this could be greater supervisory efficiency, in that regulated financial institutions might not be have to deal with the two entities having different sets of reporting requirements and procedures. There also would be little chance of the promulgation of conflicting regulations; and, presumably, there would also be less of a chance of disputes arising between the deposit insurer and the regulator as to how to deal with a failed institution.

246. CDIC, *supra* note 224.

247. *Id.*

248. *Id.*

249. *Id.*

250. *Id.*

251. *Id.*

252. *Id.*

balance is struck by having two entities working in collaboration with each other, but each pursuing its own goal."[253]

At first glance, these arguments may not appear to be applicable to the scheme set up under the U.S. financial safety net construct, particularly because the FDIC cannot close banks,[254] Furthermore, the FDIC's involvement with failed institutions is usually limited to acting as a receiver for their liquidation.[255] However, there are instances in which the FDIC can still arrange purchase and assumption transactions for failed banks,[256] and it can be appointed as a conservator if the bank is not be liquidated.[257] In addition to this, the FDIC does have some regulatory and enforcement powers.[258] Additionally, the overall theme of the two arguments, which that is that a system based on regulatory competition is superior to that of a unified regulator approach, is a common rationale put forth by U.S. policymakers for the structure of the country's financial regulatory regime.[259] Thus the CDIC's rationalization for the separation of the deposit insurer from the regulator/supervisor could very well be transferable to the U.S. situation.

While there are clear advantages to the scheme in which the deposit insurer is independent of the regulatory or supervisory body, this system is not without possible drawbacks. For instance, there is the possibility of the two entities issuing conflicting regulations. There is also the potential problem of the increased supervisory burden on financial institutions that could result from the deposit insurer and the regulator having different reporting requirements and procedures. There is also the possibility that a conflict may arise between the two entities as to how to deal with a failed institution, which could delay action to the detriment of the institution, and, possibly to the financial system as a whole.

The United States and Canada, however, have found practical ways to avoid such problems with the use of legally mandated coordination and cooperation requirements. Canadian policymakers require that all three of the safety-net players, who make up their federal supervisory system, have a seat on the board of the CDIC.[260] They also require board approval for all of the CDIC's major decisions.[261] These measures go a long way to insure that the separate entities work together to develop coordinated policies.[262] The manner in which the United States has attempted to provide the needed regulatory coordination and cooperation has already been addressed in the previous subsection.

As for the problem of increased supervisory burden on regulated institutions, U.S. policymakers have addressed this by creating the Federal Financial Institutions Examination Council. The FDIC, the Comptroller of the Currency, and the Federal Reserve Board are all members of this body.[263] Two of the primary reasons for its creation were to prescribe uniform and standard procedures for the examination of banks, and to develop uniform

253. *Id.*
254. Douglas, *supra* note 237, at 26.
255. 12 U.S.C. § 91.
256. Douglas, *supra* note 237, at 25.
257. Rebecca J. Simmons, *Bankruptcy and Insolvency Proceedings Related to Cross-Border Derivatives Transactions*, 1360 PLI/Corp 629, 639 (2003).
258. Douglas, *supra* note 237, at 28-31.
259. Greenspan, *supra* note 153.
260. CDIC, *supra* note 178.
261. *Id.*
262. *Id.*
263. Federal Financial Institutions Examination Council, *at* http:www.ffiec.gov (last modified Oct. 29, 2004).

reporting standards for all regulators.[264] In regard to the scenario in which the deposit insurer and the regulator/supervisor might disagree on how to deal with a failing institution, this is not a significant problem in the United States because, as stated earlier, the FDIC's ability to take any kind of unilateral action in such a situation is very limited.[265] However, in the case in which the FDIC can take on a role other than that of a receiver (*e.g.*, a conservator), there is a mechanism in place to prevent prolonged conflicts between it and the regulator as to how to deal with the institution. Also, the Comptroller of the Currency has a seat on the FDIC's Board,[266] which arguably strengthens coordination between the two bodies.

4. *Further Considerations*

The operation of the UK's FSCS fits well into the broad consumer protection objective of the FSA. Its ability to pay out larger compensations than previous (but lower than the United States and other EU countries), has also assisted in protecting consumer rights. On the other hand, the cost to the FSCS, which is dependent on the defaults occurring in the same contribution group, may be actually higher than for the predecessor compensation bodies. This might inhibit the development of a competitive environment for financial institutions.

The FSCS differs fundamentally from many modern compensation schemes in that it does not carry out supervision nor does it receive information on supervision of financial institutions. As mentioned above, the declaration of a firm in "default" is made by the FSCS or the FSA. Strong prudential regulations and supervision is provided by the FSA, which is supposed to support the operations of the FSCS.

As for banks, the UK compensation scheme also needs to coordinate with the Bank of England, which is the lender-of-last-resort. There needs to be some coordination to ascertain when a deposit-taking institution is declared insolvent, as the Bank will only extend emergency credit when the institution is considered still to be "viable."[267] There does not seem to be any ongoing arrangement on this matter made between the FSCS and the Bank.

There has been substantial dismay over the recent Equitable Life debacle in relation to the regulation of the FSA. While *regulatory failure* of the FSA was not the only reason for the mis-selling of guaranteed annuities by Equitable (Lord Penrose's Report makes it clear that the main failure was from Equitable's management and from the inherent deficiency of the then existing regulatory framework for insurance and pension products),[268] there has been sharp criticism that if Equitable Life did finally fail, then compensations would have to had been paid out of the FSCS.[269] This would in effect be, at least in part, a charge against the insurance industry, even though a good part of the reason for the problem was due to the FSA's regulatory failure. The situation of Equitable Life is somewhat particularized in that it is a mutual society, unable to tap the capital market to raise funds. As such, it does not have this restructuring possibility that might prevent it (but not necessarily) from failing. Also, the regulatory failure was not limited to the FSA but extended to the

264. *Id.*
265. 12 U.S.C. § 91.
266. Roberta Laskowitz, *Banking Law Research*, 590 PLI/COMM 271, 275 (1991).
267. J. Norton et. al., *supra* note 18, at 6-7.
268. Penrose Report, *supra* note 70.
269. Comment from Ruth Kelly MP.

Treasury (as well as the Department of Trade and Industry and the Government's Actuary Department, which were responsible governmental bodies at the time as well). In fact, the Parliamentary Ombudsman has most recently determined to reopen her investigation to determine the extent of the regulatory failure by these latter bodies,[270] a potential liability up to £1 billion for the UK Government.[271]

The FSA was the responsible regulator during the attempted over-valued sales of Equitable. The government-commissioned *Penrose Report* criticised the FSA's position for being based on the assumption that compensation would be available to policyholders that were disadvantaged without seeking legal assurance.[272] This would have directly and adversely affected FSCS if Equitable were declared insolvent. In the broader context, this situation brings into question whether the FSA, in a crisis situation, will inevitably seek to protect its image and institutional interests in the face of media and parliamentary criticism.[273] Even if this would be at the expense of the compensation scheme, situations such as Equitable Life leave a distinct impression that the FSA might rather redirect consumers towards the compensation scheme rather than open a public scrutiny into its regulatory actions/failures.[274]

The FSA is planning to create a sub-scheme for insurance brokers under the FSCS. There has been concern expressed over this in relation to the FSA's move to reduce the level of compulsory professional indemnity (PI) insurance to the minimum under the European Insurance Mediation Directive.[275] The issue of PI insurance has been widely criticised by the industry and may become a cause of greater compensation claims to the FSCS.[276] Insurers have raised the premiums for PI insurance leaving many independent financial advisers unable to obtain PI coverage facing a regulatory demand to cease trade.[277] This rise in premiums is in response to the number of cases in pension and FSAVC, which will incur greater compensation payout by PI underwriters.[278]

VI. Concluding Observations—Lessons to be Learned

The following concluding observations (i.e., "lessons to be learned") may be drawn with regard to the effectiveness of the United Kingdom's regulatory responses adopted under the Financial Services and Markets Act with regard to a unified regulator and its companion common compensation scheme vis-à-vis this single-regulator model's appropriateness for adoption by other countries.

270. Liz Dolan, *Just whom do you think you are kidding, Ms. Kelly?*, SUNDAY TELEGRAPH, Mar. 14, 2004, at 2. Regarding the Parliamentary Ombudsman's reopening of her investigation, *see* its 3rd Report-Session 2003-2004 (HC 910) (19 July 2004).

271.

272. Penrose Report, *supra* note 70, at 678, para. 115.

273. Kevin Brown, *Tough talk in the FSA goon show*, FIN. TIMES, June 5, 2004.

274. This is also present in the split cap scandal in which FSA is trying to force investment trusts to compensate clients.

275. Anthony Gould, *Concerns raised over FSA compensation plans*, POST MAG., Sept. 11, 2003, at 2 (regarding comment by chief executive of British Insurance Brokers' Association).

276. *The FSA must get this crisis covered*, FIN. ADVISER, Mar. 20, 2003.

277. HANDBOOK, *supra* note 184.

278. *See supra* note 276.

A. In General:

1. The creation of a mega-regulator in the financial sector is a fundamental structural and administrative policy determination for government, having a most significant long-term impact on the financial industries sector of an economy, the relevant financial institutions, and the users of both. As such, in undertaking any such radical reform, a government should have *its own clear and compelling policy objectives* that can be justified on a demonstrable "*cost-benefit analysis,*" in light of its own particular country's circumstances. A "follow-the-leader" approach by itself is not a responsible governmental approach.
2. No theoretically absolute or otherwise clear, compelling, and objectively convincing criteria exist in determining the choice between single/unified or multiple functional regulators. For all of the *pros* that can be advanced, there exist countervailing *cons.* The ultimate rationale must come from, and be demonstrable within, the given country considering adoption of such a regulatory model.
3. The issue of whether there should be a single financial mega-regulator is only a threshold policy consideration for government. There still remain two major collateral policy considerations. First, whether all financial sectors should be governed in a *functional* or *unitary manner* and under separate or unified rules. Second, whether the mega-structure should subsume and determine the nature and structure of the related deposit insurance scheme, or whether the insurer should remain an independent body (this latter point would also include the role the insurer should play in the financial system and whether there should be common or segregated compensation schemes for all the financial sectors). Substantially differing policy and practical considerations are entailed in each of these governmental considerations. These considerations depend upon a country's particular economic, financial, legal, political, social, cultural, educational and historical circumstances.

B. The UK-FSA: The Single Regulator

1. In the case of the UK, this dramatic governmental decision in favour of a unified mega-regulator was made in the domestic backdrop of a series of banking scandals mishandled by the Bank of England, international and EU pressures to make the Bank of England *independent* from the Treasury in monetary matters (with the attendant government desire to insulate the Bank from involvement in any future bank regulatory and supervisory failures), increasing EU/EC banking and other financial directives requiring a much more *rule-based* approach to bank supervision/regulation than that under the traditional Bank of England informal, discretion-based "*moral suasion*" approach, a change in Government from an extended period of Conservative rule, and a perception within the concentrated London City financial markets that there was a trend underway toward an increasing integration of the different financial markets and financial institutions and toward a rise of financial conglomerates. There was a general perception that the then current UK regulatory system was not functioning well and was not best-suited to impending EU requirements or to perceived marketplace changes. Also, the UK financial markets are highly concentrated and highly developed.
2. A key determining factor that led to the establishment of a single regulator in the UK was to separate monetary policy from financial policy and to insulate this mon-

etary autonomy of the Bank of England from any further banking crisis. Such a factor is clearly *particular* to the UK and possibly to other EU (and EU-aspiring) countries. Thus, whether other countries should use a UK-FSA model will require those countries to ascertain their own compelling governmental policy objectives, hopefully on an *ex ante* basis.

3. With respect to the UK enactment of the FSA legislation of 1997, this was an interim framework piece of domestic legislation. In fact, when the new Labour Chancellor announced the Government's decision on this fundamental policy matter, there had been only a scant general reference to this possibility in the Labour Party *Manifesto* and no prior public discussion or debate. This announcement was without the benefit of any comprehensive government *White* or *Green Paper*, or any Report on the subject. The UK Parliament would come to spend over 2-1/2 subsequent years of protracted discussion and hearings to complete the final implementing legislation, the FSMA. But again, notwithstanding the usefulness of the Parliamentary hearings, the legislative drafting stage was without the benefit of any comprehensive policy analysis or governmental or independently commissioned report (save and except for a rather general internal FSA *Occasional Paper)*.[279]
4. The UK-FSA has been able to initiate a number of fundamental new regulatory reforms in the UK including, in particular, the launch of its fully integrated *Handbook of Rules and Guidance* (under ss 138 and 157 of the FSMA). Whether all of the benefits of a fully integrated rules system will prove a high-point of the new reform remains to be seen. But, what is clear is that all this new rule-making has produced one of the most complex and developed integrated regulatory models in the world at this time. The Japanese and German FSA adoptions have chosen not to replicate this highly legalistic aspect of reform. And certainly, an emerging or developing economy should be quite cautious in moving headlong into such a legalistic approach, as to any such country would really need in place already a highly developed financial legal infrastructure (including developed administrative enforcement and judicial processes).
5. The FSA is one of the largest and most powerful financial regulators in the world at the present time, both in terms of firms regulated and the size and scope of the financial markets covered it presides over. The FSMA, establishing the FSA, has created an extended new unitary regulatory regime that includes both oversight of financial institutions and markets as well as an integrated overall, comprehensive financial regulator in terms of including the Financial Ombudsman Scheme, Financial Compensation Scheme and Financial Services Appeals Tribunal and Financial Compensation Scheme. It must be accepted that this is a remarkable administrative/governmental achievement. However, in attempting to transplant such a system into another (whether developed or developing) jurisdiction, a country needs to contemplate fully and in advance the inherent problems of transplanting "foreign" legal structures into a different legal environment.
6. The UK FSA is intended to be a mega-regulator dealing with all the UK financial sectors. Its four statutory objectives (which are seen by many as creating certain major inherent institutional and policy conflicts) are: maintaining market confidences; promoting public awareness; protecting consumers; and reducing financial crime. The

279. Briault, *supra* note 14.

UK-FSA is intended to be an *operationally* independent, accountable and transparent private company-regulatory body that reports to and is primarily accountable to the UK Treasury, with a limited degree of accountability to the Parliament. The FSA is structured according to statutorily prescribed "principles of good governance—to be based largely on a cost-benefit, cost-effectiveness bases. The UK FSA is given strong and broad enforcement powers. However, the UK FSA does not provide a coherent solution to the regulatory choice between *unitary* and *functional* regulations.

7. Yet, while the operational independence of the FSA appears, on its face, to be adequate, it is limited by inadequate personnel and financial resources and no effective final accountability to Parliament. Also, the nominal independence of the FSCS is stated in the MOU entered into and exchanged with FSA; but, *de facto*, there is a strong reliance by the FSA for its senior appointments and for information supply on financial institutions.
8. The extent of any immediate increase in regulatory efficiency and effectiveness within the new unified regulatory regime remains unclear after seven years since initial adoption and after four years of implementation. At this time, for other jurisdictions contemplating adoption of a UK-FSA model, the arguments for unification do not seem to be compelling when analysed in detail. The regulatory costs and compliance burdens imposed on firms have increased significantly, which increase is not necessarily justified by the limited benefits that the system has provided. The administrative powers and enforcement tools of the FSA have been substantially strengthened, but this has led to a significant degree of legalism, proceduralism and judicialism as to these processes. Further, any associated regulatory benefits (e.g., consumer protection) nevertheless appear at best marginal especially in light of the continuing scandals that have occurred as to the FSA. The UK regulated industries complain about the rising costs that the regulatory change has brought forward: and, within the London financial industries sector (*e.g.*, the most recent CPS March 2000 Report on the FSA), the perception of the FSA is generally poor.
9. Consumer protection is one area in which improvements appear to have been realised, although consumer education and financial capability still seems inadequate. It is questionable whether the information improvements generated in this area can be considered to offset the apparently high levels of additional costs imposed on the regulated community. The price of this benefit may be too high for the financial institutions. Also, some conflict between the objectives of the FSA as to consumer protection and the promotion of competition, appear to have arisen.
10. Recent scandals (particularly Equitable Life) and sustained industry criticisms have also resulted in obvious and significant reputational damage to the FSA., with disproportionate risks of *reputational contagion* existing. This lowered reputation may compromise the high regard required towards a financial regulator.
11. As noted earlier, the increasingly strong enforcement capability of FSA has been both praised and criticised.

C. The UK FSCS: The Common Deposit Insurance Scheme

12. With regard to the FSA generally, and the FSCS more specifically, there has been an appearance, at least, of some decline in *moral hazard* since its creation. However, it is most difficult to make any clear evaluation in this area in light of the rather

opaque and informal ways the UK regulators have often dealt with financial institution crises (*e.g.*, "lifeboat operations). This area will have to be carefully monitored and observed over time.

13. There does not appear to be any clearly defined role for the FSCS within and among the larger financial safety net arrangements in the UK. This may be criticised as not adhering to the Financial Stability Forum's *Guidelines.* Moreover, within the UK, the role of the deposit protection function has traditionally always been regarded as being relatively marginal. Its purpose in the banking area, at least, has *not* been to prevent runs directly or to support the stability of the financial system more generally but only to provide some level of cover for those whose individual or personal hardship may be most severe. It is thus more a mechanism of *ex post facto* consumer protection support rather than a formal instrument of financial crisis resolution or financial stability management. Such an approach is *not* in step with modern international trends in this area.
14. The debate concerning the relationship between the regulator and the deposit scheme operator has been limited, although, the UK opinion appears to lean towards an "independent" FSCS scheme. Whether the extent of the current nominal legal independence of the FSCS is matched by operational independence is less clear. The issue of common fund or sub-fund divisions has also not received much attention. As the sub-funds are effectively run on a sector basis, some difficult legal or organisational issues nevertheless will arise. More significantly, the recent Equitable Life scandal illustrates the policy conflict risks and reputational contagion risks and dangers of not only having a common compensation scheme but of a scheme that is closely linked to the financial institution regulator/supervisor.
15. As to the issue of how to treat the deposit insurer, a country needs to determine initially what it expects of its deposit insurer. For instance, the UK approach has been a rather marginal "pay-box" type of mechanism; while the international approach/trend favoured by countries such as the U.S. and Canada, the IFIs (e.g., the IMF) and the international "standard-setter" in the deposit insurance area (i.e., the IADI, in conjunction with the FSF) is for an independent and separate insurer with more comprehensive functions linked to crises resolution and financial stability. If a government desires this latter approach for its deposit insurer, then such policy issues as to whether it is best to have the insurer tied-up into a consolidated framework, including being controlled by the supervisor (with all the inherent potential conflicts of policies/interest that might arise), need to be sorted out clearly and carefully *ex ante.*
16. The FSMA bundles all of the UK's previously separated compensation schemes under a common scheme, the FSCS. The FSCS carries forward the prior UK culture of treating these compensation schemes as more marginal, pay-box types of mechanisms, though some enhancement has been required under EU directives. The FSCS is operationally independent of the FSA, but is ultimately accountable to the FSA.
17. There has been substantial criticism of the FSCS's common compensation scheme. For example, the recent FSA involvement in the Equitable Life scandal raises serious questions about the efficacy and inherent policy conflicts of such a common scheme, the appropriateness of a scheme that is directly tied into the supervisor/regulator, and about the resulting dangers of reputational contagion. This scandal has been

subject to a major and highly critical government-commissioned report (i.e., the *Penrose Report*) and to investigation by the UK Parliamentary Ombudsman (who has most recently announced that she would be reopening her inquiry into this scandal to determine the extent *regulatory failure* on the part of the Treasury, Department of Trade and Government's Actuary Department contributed to the near £1 billion pounds of policy-holder losses).

D. UK FSA/FCSC: An International Model?

1. The UK FSA/FSCS regulatory model was never designed to serve as an international 'model' to follow by other countries.
2. Each country situation should be seen as *sui generis*, with the best informed decision dependent on taking regard of local historical, social, economic, financial market, legal/regulatory political, cultural and educational factors and conditions.
3. Since 1997, the majority of countries that have looked to a UK-FSA mega-regulation framework as a starting-point for internal financial regulation reform purposes primarily have been developing, emerging and transitioning countries, virtually all of which had undergone recent significant financial and/or political crises. Moreover, most of these countries were/are also under substantial domestic and international (often through IFI's and RFI's) pressure to produce major financial sector reforms: the UK-FSA model, on its face, appears to provide a manageable, simplified and efficient model of reform for these types of countries to consider, particularly for those countries starting at a *near-ground zero* or incipient stage in terms of their development of a viable financial sector regulatory infrastructure, of robust multiple financial markets, and of adequately trained and sufficient administrative personnel in the financial sector area. Notwithstanding the possible adaptability of the single-regulator model for a developing/transitioning country, as a general proposition, the exact nature and specifics of the adoption would still depend heavily upon the specific circumstances/requirement of the country.
4. The single regulator model also has a superficial appeal for governmental and intergovernmental bureaucrats and policymaker as it implies simplicity and efficiency; but this should only be the starting point for a country's decision. There is in fact, no one set mega-regulator format, but a broad range of structural possibilities and variants (*e.g.*, consider the Australian model). In considering each structural possibility, there will be sundry important and particular policy and practical determinations to be made.
5. In an industrialized country, such as Japan, that has recently adopted an FSA-type model, it adopted a modified model deemed suitable to its own particular country circumstances and it still kept its deposit insurance separate and independent. Moreover, in Germany, which recently has adopted a quite diluted form of FSA model, it has maintained its various pre-existing, separate compensation scheme. In both Japan and Germany, the move to a qualified FSA regulatory model resulted from significant pressures for effecting some form of regulatory change to separate financial supervision/regulation further from the central bank; but, these reforms were without the benefit of any comprehensive government or commissioned policy report evaluating the costs and benefits of such structural reforms or presenting a compelling policy

bases for these reforms. Moreover, the German reform was considered by many as a ' follow-the-leader' reaction as to the UK reform.

6. A country such as the US that has undergone recent major financial sector regulatory reform (after considering at length the perceived changes in financial markets and among financial institution groupings) specifically rejected a consolidated regulatory structure in favour of maintaining a segregated (but interconnected) structure of functional regulation within a 'financial holding company' context, with enhanced interagency information exchanges and cooperation, and with a separate, comprehensive and independent deposit insurer.
7. As indicated above, emerging, developing and transitioning economies should not be lured or pushed into adopting a mega-regulator structure simply because of its superficially and deceptively appeal of simplicity and efficiency. Such countries need to consider carefully their respective current stage of bank and other financial market development, the basic governmental policy priorities in this area as to financial market growth and stability, the available level of country financial and expert personnel resources, and the best strategic "sequencing" plan of implementation for a particular country. What needs to be remembered is that the UK-FSA model was designed for a highly developed and concentrated system and under very particularized circumstances. On the other hand, a developing country can have a developing (but not developed) banking/credit system and a very incipient (if existent at all) capital markets. In such a case, the best approach for the moment well could be keeping the Central Bank structure (albeit somehow ring-fenced for independence reasons); creating a separate securities authority to focus specifically on a staged capital market development programme; and planning an eventual sequencing in of a "modern" type of deposit insurer.

E. In Sum:

1. To date, the actual UK experience with its FSA, seven years on since the original Bill and nearly five years on since the final Act, fails to present a compelling practical or policy case, in and of itself, for an industrialised country (with a developed and well-functioning financial sector regulatory framework and without specific and significant internal and/or external pressures) to undertake major regulatory consolidation along the lines of the UK-FSA model.
2. In terms of the UK-FSA's performance to date, a number of significant concerns (*e.g.*, policy conflicts, over-regulation and reputational contagion risks) have been raised with respect to the efficacy of the new mega-regulator. Moreover, as a practical matter, the UK FSA has not shown itself to be particularly adept in fending-off financial failures/scandals; and, there has been widespread industry criticism of the FSA as being an "overly intrusive regulatory regime" that has made the costs and burdens of the new regulatory scheme too high.
3. The direct and specific impact of all this on financial compensation scheme design and reform along current UK lines must be generally considered to be wholly incomplete and non-compelling due to the traditionally limited and only supporting role of such schemes within the UK financial system, the recent nature of the contrary international reform trends in this area, and the serious policy issues raised by the recent Equitable Life and other recent financial scandals. In fact, the UK model

provides little, if any, guidance as to how to interface a "modern" deposit insurance scheme within the mega-regulator structure.

4. The UK FSA model does not provide any coherent answers to the ongoing policy debate concerning *unitary* versus *functional* regulation.
5. The trend toward having "modern," separate and independent deposit insurance schemes appears to present compelling policy considerations for *not* having the compensation schemes authentically subsumed under a mega-regulator structure.
6. Overall, at this point in time, the cost-benefit and cost-effectiveness of the UK-FSA do not seem to justify this radical behemoth of financial sector reform. In addition, the FSMA treatment of the deposit-insurer under a common scheme does not appear to be consistent with modern, international trends (*e.g.*, as recommended by the IMF and IADI, in conjunction with the FSF) as to the insurer's role in financial crises resolution and respecting financial stability, separateness and independence from the primary financial institution supervisor/regulator. As such, a country looking at the possible adoption of a UK-FSA like unified regulatory model would need to undertake its own policy and practical analyses and deliberations on the basis of its own country situation and requirements.
7. In particular, developing, emerging and transitioning economies should cautiously approach the "mega-regulator" issue with much hesitation and forethought.