

# Cultural change in the FCA, PRA & Bank of England

Practising what they preach?

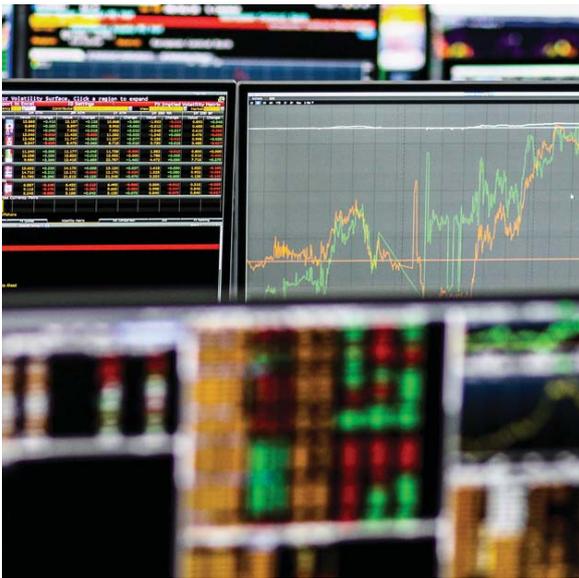




# Cultural change in the FCA, PRA & Bank of England

Practising what they preach?

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## About New City Agenda

New City Agenda is a not-for-profit financial services think tank and forum founded by Lord McFall, the Rt Hon David Davis MP, and Lord Sharkey. The Rt Hon David Davis MP stepped down as a director of New City Agenda in July 2016.

We receive support from Which?, Prudential, Berenberg UK, The London Stock Exchange Group and City of London Corporation.

## About Cass Business School

Cass Business School is part of the City University London. It is the only leading business school based in the City of London.

Cass houses, Ethos: the Centre for Responsible Enterprise. Ethos is a world leading research centre focusing on themes of responsibility, sustainability and governance.

# Preface

When we founded New City Agenda in 2014 we did so with the ambition of helping Britain's financial sector realise its enormous social and economic potential.

**Financial crises always lead to demands for greater regulation.** The 2008 global financial crisis was no exception. Since the South Sea Bubble, politicians and regulators have been promising that next time it will be different. We are told the people at the top of the institutions responsible will be held accountable. This hasn't happened.

**A deep seated culture of box-ticking had developed in the UK's financial regulators.** Instead of concentrating on the big issues, regulators spent valuable time adding ever more detailed rules and procedures and giving consumers ever more complicated information. This is likely to increase confusion and cost rather than establish clarity.

**The administrative cost of the regulators is now almost £1.2 billion a year** – six times greater than in the year 2000. There are now over 13,000 pages of detailed rules and guidance from the PRA and the FCA. The FCA handbook costs £3,641, the same to buy as a second hand Mini Cooper. Complexity and box-ticking benefit lawyers and gives a veneer of reassurance, but it increases costs and makes regulations more difficult to understand and enforce and easier to manipulate or avoid. It also distorts competition. Big firms have armies of officials and a close relationship with the regulators to help navigate this complexity. Smaller firms and new entrants often find themselves reeling from the complexity, with only a call centre at the regulator to help them out.

## Our findings are clear:

**Unless we change the culture of regulators we will be sleep walking into the next financial crisis:**

This will have a devastating effect on our economy and our political system. Memories of the 2008 crisis are rapidly fading and industry lobbying has become more intense. There is a clear and present danger that we will repeat the mistakes of history. Much needed change is already being watered down. The attention of politicians has moved on. The vote to leave the European Union will mean that the UK will be in full control of its regulation, but it will also have significant resource implications for regulators over the coming years. Regulators need to redouble their efforts to change their culture and move away from the bureaucratic and ineffective approaches of the past.

**PRA and Bank of England have further to go to improve transparency and reduce group think:** The Bank and the PRA have been trying to transform their culture with their 'One Bank' initiative. There have been improvements. But there is a risk the Bank and the PRA will slip back into being an opaque institution blighted by group think. It needs to engage with the public in a meaningful and sustained way. The odd talking shop is not enough. The Bank needs to actively engage with the public and consider the needs of society. More needs to be done to prevent group think. Bringing more external challenge into the Bank and the PRA would be a good start. The Bank and PRA are disagreeing with the views of Sir John Vickers that banks need to hold more capital because they have an unevicenced faith that their supervision can ensure that large complex banks do not 'take excessive risks'.

**Andrew Bailey must implement a comprehensive programme of cultural change in the FCA:** Previous attempts to reform the FCA have been blown off course. Leadership changes and the perception of political interference were in danger of making the FCA into a timid and cowed regulator. Cultural change at the FCA should be the primary aim and responsibility of the new CEO. Andrew Bailey will need to demonstrate independence from politicians and the industry. This will require establishing the key purpose and values of the regulator and the metrics used to judge its performance. It should also make changing the culture in financial firms its number one priority – it can't franchise this job out to other bodies. The FCA should make greater use of its new powers to name and shame misleading adverts, obtain redress for consumers and take action against senior banking executives. It should take stronger action to promote competition rather than relying on re-writing the information given to consumers. Finally, it should set up an independent evaluation office within the regulator, as has been done by the Bank of England, to ensure that it learns from the mistakes and successes of the past.

**Politicians should support cultural change and tackle the culture of secrecy in UK regulators:**

Politicians influence the culture of the regulators through the framework they set, the statements they make and the people they appoint. Politicians have implemented a legislative framework which supports a culture of secrecy within regulators and damages accountability. It means that the FCA can negotiate secret agreements with banks and then refuse to disclose them. By restricting access to information the culture of secrecy also damages the ability of the National Audit Office and others to properly evaluate the regulators' impact. Politicians must reform the legislation so regulators are transparent and can be held accountable. They must also appoint diverse leadership and board members.

Finally, if there is one thing we have learnt from our work at New City Agenda, it is that if you want to assess the culture of an organisation you need to talk to frontline staff. We are grateful to the current and former staff at the regulators and other stakeholders who gave up their time to speak to us. Their willingness to discuss the issues meant that the lack of transparency shown by the refusal of the FCA and PRA to cooperate with our research didn't impede the project.

To help restore trust in financial markets the Bank of England, PRA and FCA need to demonstrate that they are acting on behalf of the public. This will require a change of culture and for politicians and regulators to do more to understand and act on the concerns of consumers and small businesses. This report serves as a warning against the hubris, complacency and refuge in detail within regulators which contributed to the financial crisis.

**The Rt Hon the Lord McFall of Alcluith**

**The Lord Sharkey**

29th August, 2016



# Executive Summary

## Background and Purpose

**A failure of regulation.** In the lead up to the financial crisis, UK financial regulators had adopted a 'light touch' approach. This was supported by the Boards of the regulators which were dominated by those with industry experience and encouraged by politicians who thought the financial services sector was the goose that laid the golden egg. They hoped that by avoiding too much intervention, they could help to create a thriving financial sector and drive financial innovation. This may have been true in the short term. But in the long term regulators did not identify or act on serious shortcomings in financial institutions until it was too late. The result was the failure or near failure of key financial institutions with profound consequences for the entire economy. Politicians and regulators also failed to hold senior banking executives to account for fraud and misconduct.

**Reforming regulation.** To address these regulatory failures, the UK Government sought to fundamentally transform the UK regulatory landscape. The Bank of England was given greater responsibility for financial stability. The Prudential Regulation Authority was created to take a more judgement-based approach. The Financial Services Authority became the Financial Conduct Authority with the aim of improving the conduct of financial institutions by taking a more consumer-focused and proactive approach.

**A change in culture?** Simply changing rules and regulations was not enough. What was required was a change in the culture of the UK's financial regulators. To achieve this, each regulator launched cultural change initiatives. In this report we looked at how regulators have responded to crises in the past, how the regulators have sought to change their culture since the 2008 crisis, what impact it has had on employees, and whether stakeholders think this has made regulators more effective.

## Methods

**This report is based on the work of the New City Agenda over the past year:** We have hosted a number of lectures over the past year on regulation from Professor Anat Admati, John Kay, Martin Wolf, Antony Jenkins, Andy Haldane, David Pitt-Watson and Sir John Vickers. We have also reviewed all major documents detailing cultural change in the UK's regulators, including various reviews of regulation, speeches by politicians and senior regulators as well as third party reports. In addition, we interviewed current and former regulators at both senior and junior levels, people involved with the governance of financial regulators, and a number of others stakeholders including large and small financial institutions, consumer and SME groups, industry representative groups as well as experts. In total, we have interviewed over 60 people.

## Findings

**Stuck in a regulatory spin-cycle.** Financial regulation in the UK operates in cycles. Following a crisis, politicians respond to public outrage by introducing new legislation and more detailed regulation. However this new regulation is progressively watered down, not sufficiently enforced or repealed. This lays the foundations for the next crisis. In the past this spin-cycle could take decades. Today it seems to be only a few years before lessons from the past are forgotten. History teaches us the most crucial thing is not what regulators do directly after the crisis, but how they hold onto the lessons they learned, integrate them into their culture and ensure that this continues to guide their action.

**A deep seated culture of box-ticking.** Through these cycles of reform the UK had created a regulatory system which is costly, complex, centralised and captured. The administrative costs of regulators are now over £1.2 billion a year – six times what they were in 2000. There are over 13,000 pages of rules, guidance and supervisory statements published by the FCA and PRA. The FCA handbook costs £3,641, the same to buy as a second hand Mini Cooper. This complex box-ticking gives a veneer of safety and security. But it



also creates regulation which is both bureaucratic and ineffective. It can detract the attention of regulators away from wider systemic issues. It also feeds an industry of lawyers and compliance consultants while obscuring more important public concerns. It benefits big banks and damages competition from new entrants and new business models.

**From rhetoric to reality.** In addition to changes to powers, focus and structures of the regulators, each of the regulators sought to change their internal cultures. The Bank of England and the Prudential Regulation Authority undertook this transformation through the 'One Bank' initiative. The Financial Conduct Authority also made piecemeal efforts to change its culture. Each regulator has changed the tone from the top. They have also changed internal processes like performance evaluation, staff development and processes of collaboration. The Bank of England and PRA have laid out a detailed plan for delivering a single culture for these two organisations. In contrast, the FCA has been blown off course by pressure from powerful stakeholders.

**Forgetting the lessons of the crisis: Much needed improvements are already being watered down.** The FCA has scrapped its review of bank culture and is failing to make effective use of its new powers. The CEO of the FCA was removed in what was widely perceived to be a political sacking orchestrated by the Treasury. The PRA is disagreeing with the views from Sir John Vickers that banks need to hold more capital, because it has an unevincenced faith that its supervision will stop banks taking excessive risks. The Government has already removed a key recommendation of the Parliamentary Commission on Banking Standards by weakening the rules – known as the 'reverse burden of proof' – which were designed to ensure individual senior bankers were held accountable for misconduct. This was a particularly swift example – the fastest in the 300 year history of financial regulation - of the process of watering down of the regulatory framework which inevitably follows as memories of the crisis fade.

**Internal barriers to cultural change.** Within the Bank of England / PRA, we found that the 'One Bank' strategy received a mixed assessment from employees, with some stating that it was not yet having a positive impact on the way they worked. Within the FCA we found that employees felt they'd been better supported to take a more proactive approach but this was in danger of fading. We identified some significant barriers to change at the FCA including the extent of bureaucracy and silos in the organisation, the organisation being overloaded, lack of opportunities for career progression, and internal and external pressure on the organisation.

**External perceptions.** Stakeholders viewed the Bank of England and PRA as well respected high quality regulatory agencies. However some stakeholders thought they lacked transparency and could be closed and even arrogant. Their assessments of the FCA were much more mixed. Although many in the banking industry questioned the tougher approach of the regulator under the former director Martin Wheatley, most acknowledged that the regulator had been given a renewed sense of vigour. Stakeholders identified a range of problems with the FCA including variable quality of staff, excessive box-ticking, a culture of secrecy, a lack of willingness to use new powers granted by Parliament, a lack of clarity about what the regulator was trying to achieve, a lack of independent evaluation, internal silos, being overloaded with data and poor engagement with small players in the financial industry. Stakeholders noted some common issues in each regulator including increased regulatory burden, increased complexity which have created increasingly slow and narrow processes, a sense of fear of not being supported by superiors and the proliferation of administrative activities. It was seen as vital that senior managers supported frontline staff to exercise judgement rather than rely on box-ticking.

## Recommendations

**Bank of England / PRA.** The Bank of England and the PRA need to conduct a transparent and independent assessment of the progress made with their cultural change programme and have it independently audited. The Bank needs to continue its efforts to improve on two core aspects of its strategy: openness and accountability. This means extending engagement with the public and beyond the closed circle of the financial sector. One way to do this would be building on the success of the Open Forum by demonstrating that this is more than just a one-off PR exercise. The Bank also needs to tackle group think by doing more to encourage internal and external challenge and independent thinking. There have been some steps in this direction with the 'Bank Underground' blog. The PRA also needs to better acknowledge the interactions between misconduct and prudential issues and that significant bank misconduct can have issues for financial stability.

**FCA.** The FCA needs to ensure it does not get blown off course with its attempts to institute a new culture. This means developing a new comprehensive programme of cultural change, establishing the key purpose of the regulator and the metrics which will be used to measure success. Senior leadership need to demonstrate independence from politicians and the industry and provide support for frontline staff to take a more proactive approach. The FCA also needs to ensure it makes use of the new powers it has been given by Parliament to name and shame misleading adverts, get consumers redress and take action against senior executives. The regulator needs to reduce internal hurdles and departmental silos within the organisation. It also needs to ensure that medium and smaller sized organisations have better access to knowledgeable supervisors. The FCA needs to ensure it is more transparent and develop new ways of consulting with the public and gathering information about risks. The FCA should build on recent successes such as project innovate and payday lending regulation in order to develop new ways of engaging with those who are regulated. The FCA has recently done a lot of work around behaviour biases among consumers. It should also understand how its own behavioural biases – such as risk aversion or overconfidence - influence its own activities. It should make cultural change in firms its number one priority and ensure it has genuine internal competence to understand and regulate culture. Finally, it should ensure it questions its policies through regular processes of external challenge by setting up an Independent Evaluation Office as exists within the Bank of England.

**Policy Makers.** Politicians are always tempted to directly influence the regulators. However excessive meddling can be counter-productive, reducing morale in the regulator and sending it in many different directions. There is an urgent need to reform the legislation which has allowed a culture of secrecy to develop in regulators by removing section 348 of FSMA which currently places blanket restrictions on what information regulators can disclose. The current framework has damaged efforts to hold regulators accountable. There remains a strong case for introducing a duty of care owed by financial services firms to their customers. Politicians need to ensure they appoint boards which provide a diverse range of experience – not just people from the financial industries. Finally, they need to ask questions about what is happening on the frontline and understand the views of staff, consumers and SMEs about the culture of the regulator.

**Financial services industry.** The banks and other industry stakeholders need to update their perceptions of regulatory agencies and recognise they are not always the 'B team' or inferior to those who work in the industry. They need to move away from often unhelpful generic criticism of the regulators. Instead, they should engage with more focused and specific ways of improving regulations and regulators. There is also a need to recognise that complaining about excessive tick-box regulation and then demanding more boxes to tick (in the name of certainty) can be counter-productive.

## Introduction

**The financial services sector is a vital part of the UK economy.** In 2014, the sector contributed £126.9 billion worth of value to the UK economy, over 9% of GDP. It employs 1.1 million workers. The financial sector is a leading exporter in the UK economy. It also pays £24.8 billion in tax each year.<sup>1</sup> However, in addition to being a source of value, the financial sector can also be a source of instability. In the 2008 financial crisis, UK taxpayers had to contribute £130 billion to bail-out the UK banking sector – equivalent to £2,000 each for every man, woman and child in the UK.<sup>2</sup> Over £54 billion has been paid out by the major retail banks and building societies for misconduct scandals such as Payment Protection Insurance and mis-selling complicated interest rate swaps to small businesses.<sup>3</sup> Standard and Poors has said that conduct and litigation charges are now 'a way of life' for the UK banking industry, and that some form of charge seems probable every year for the larger banks.<sup>4</sup> Growth in productivity declined and has only been sluggish in recent years. Real wages and family living standards have suffered to an extent unprecedented in modern history.<sup>5</sup> The crisis and the scandals all have a financial cost – but they also have a social cost: Small businesses forced into bankruptcy, livelihoods ruined, jobs destroyed, opportunities lost. These can have a very real impact on society and people's health and well-being.

**Public trust in financial markets has also been damaged.** In a speech to New City Agenda, Andy Haldane, Chief Economist at the Bank of England highlighted that the words most used by members of the public to describe financial markets were 'corrupt', 'manipulated', 'destructive' and 'greedy'. Among the Bank's usual contacts in the financial sector the word was 'regulated'. He said that these results indicated:

*'A Great Divide between the views of financial insiders and outsiders, between the perceptions of producers and consumers of financial services, between the silent majority who buy and the vocal minority who sell financial products, between the echo chamber of the elites and the voting chamber of wider society. They underscore just how far finance still has to travel to regain its social licence.'*<sup>6</sup>



An important part of ensuring the success of the UK financial sector and its contribution to society is that it be well regulated. The UK has some of the most high profile regulators in the world including the Bank of England, the Prudential Regulation Authority and the Financial Conduct Authority. What UK regulators do today is copied tomorrow by other financial regulators around the world.

In the lead up to last crisis we saw gradual adoption of a light-touch approach to regulation by UK regulator – the Financial Services Authority. The Board and senior leadership was dominated by those who worked in the financial services industry, leading to group think and a lack of internal challenge. The Bank of England believed that the UK banking system in 2007 was more resilient than it had ever been. There was also a deep-seated culture of box-ticking which asked many detailed questions about processes but overlooked key questions about the business models of banks and whether they were stable and delivered fair treatment for consumers. This drove a permissive culture within the regulator which meant many activities by banks went unchallenged. This resulted in increasingly risky activities and financial innovation which fuelled a boom in financial markets. But it also laid the foundations for the failure or near failure of major financial institutions. These failures had major consequences for the UK and global economies – which are still being felt nearly a decade on.

## Transforming Regulation

Following the financial crisis, there was an attempt to transform the regulatory landscape. The aim was to create regulators which were much more judgement based, focused on systemic questions and were forward looking and proactive.<sup>7</sup> This led to the changes within the Bank of England, the creation of the Prudential Regulation Authority, and the creation of the Financial Conduct Authority.

Following these structural and legislative changes, there was also supposed to be a transformation of culture within each of these regulators. The Bank of England sought to develop a more open and accountable culture.<sup>8</sup> The Prudential Regulation Authority would seek to take a more systemic view and implement a forward looking and judgement based approach.<sup>9</sup> The Financial Conduct Authority would also seek to adopt a more proactive and judgement based approach, focusing more on the overarching conduct of financial institutions.<sup>10</sup>

There are signs that the UK financial regulators are starting to transform their culture. If we simply listened to the tone from the top, we would hear much talk about the adoption of new values within each of the financial regulators. For instance the Governor of the Bank of England has championed the 'One Bank' strategy which promises to instil a culture based on four pillars: 'diverse and talented', 'analytical excellence', 'outstanding execution' and 'open and accountable'. The FCA has also sought to develop a culture which was more consumer-focused, transparent, forward looking and judgement based. Despite attempts to transform culture, there is still a big question mark over the extent to which this is more rhetoric than reality.

This report aims to explore the extent to which financial regulators in the UK have been able to transform their culture. We consider how the historical background has shaped the culture of UK financial regulators. We will also ask how financial regulators have instilled a new culture and what impact this has had within their organisations, and detail key stakeholders' assessments of changes in culture.

## Overview

**Chapter one** looks at history of financial regulation in the UK. It charts a centuries-long cyclical pattern of regulation whereby governments react to crises by increasing regulation which is gradually undermined, creating the conditions for the next crisis. It argues that this created a regulatory structure which was costly, complex and concentrated and highlights what went wrong with the culture of the FSA. It then examines how the UK regulators responded to the 2008 financial crisis. This charts out the new regulatory structure which emerged out of this crisis.

**Chapter two** explores how the key UK financial regulators – the Bank of England, the Prudential Regulation Authority and Financial Conduct Authority – have sought to transform their culture. It also looks at how employees have responded to these changes. We find that each financial regulator has introduced comprehensive changes. However while the Bank of England and PRA have been more consistent in their culture change initiative, the FCA risks being blown off course.

**Chapter three** considers stakeholder responses to the change in culture within the regulators. We find that while stakeholders have generally positive assessments of the Bank of England and PRA, they see the FCA in a much more mixed light. We also identify some cross cutting issues which were brought up by the stakeholders we spoke with.

**Chapter four** provides an analysis of the results. It brings together our detailed observations into an over-arching narrative.

**Chapter five** provides a set of recommendations to each of the regulators, to politicians and to the financial services industry.





# Historical Background: UK Financial Regulation Prior to 2008 and responses to the crisis

As long as there has been markets in the City of London, there has been regulation. The earliest recorded regulation of the City was a statute in 1284 which empowered the Court of Aldermen to license brokers. As part of our research we have reviewed the history of financial regulation in the UK starting with the South Sea bubble in 1720 right through to the aftermath of the 2008 financial crisis. The liberalisation of the financial sector in 1986 meant that the sector moved from more informal regulation based on close relationships in the City towards more formalised regulation. This process of formalisation started the rise of what has come to be seen today as excessive box-ticking. There was also the centralisation of financial regulation. In 2000 there was a move from a range of different specialist financial regulators to a single regulator which covered many thousands of firms and was responsible for consumer protection and financial stability.

## Never-ending cycles of regulation

This long history of attempts to regulate the financial industry in the City of London shows a pattern which is remarkably familiar. They show a clear cyclical pattern which is evident to this day. First there is mounting bad behaviour in financial markets which leads to a serious economic or financial problem and associated misconduct. This is followed by public moral outrage about the financial industry. The Government then steps in to impose legislation. Following a crisis or scandal, policymakers tend to increase regulation, give regulatory agencies new powers and reorganise their structure. However, the new powers are often undermined over time. This results in a new kinds of financial innovation, pressures for light-touch regulation from politicians and an overconfidence from regulators that they are now cleverer and more effective than in the past. This effectively lays the groundwork for a new crisis and another round of regulation.

The length of these cycles can vary, depending on the prevailing political and economic environment. In 2015 the Government removed a key recommendation of the Parliamentary Commission on Banking Standards by weakening the rules – known as the 'reverse burden of proof' – which were designed to ensure individual senior bankers were held accountable for misconduct. This was a particularly swift example – the fastest in the 300 year history of financial regulation - of the process of the watering down of the regulatory framework which inevitably follows as memories of the crisis fade.

## Length of time before financial regulation watered down

Legislation	Method of change	Length of time before watered down
Act to Restrain the Numbers and Practices of Stock Brokers and Jobbers (1697)	Lapsed in 1707 following intensive lobbying by the City of London who were worried about the undue costs it imposed on brokers.	10 years
The Bubble Act (1720)	Act was repealed in 1825 when the Attorney General said that "its meaning and effect were altogether unintelligible".	105 years
The Bank Charter Act / Joint Stock Banking Act (1844)	Limited liability for banks was introduced in 1857 when the Joint Stock Banking Act was repealed. Restrictions on expansion/mergers were also removed.	13 years

Legislation	Method of change	Length of time before watered down
The Colwyn Report (1918)	The report warned of the danger of further mergers in UK banking and called for greater Government control. This informal policy against mergers remained in place until the 1960s. <sup>11</sup>	~40-50 years
Financial Services Act (1986)	City Practitioners demanded Sir Kenneth Berrill's (Chair of the SIB) head on a plate and he was replaced. <sup>12</sup> Standards were watered down under the "New Settlement" in 1989. Rules made by the Self-Regulatory Organisations no longer had to be "equivalent" to those of the Securities and Investments Board.	3 years after the original Act. 19 months after the regulation had come into force
Financial Services and Markets Act (2000)	2004/05 – the FSA found itself under significant political pressure to deliver light-touch regulation and changed its approach with a move to Principles-Based regulation.	4/5 years
Banking Reform Act (2013)	The 2013 Act was due to introduce, from March 2016, a "presumption of responsibility" which would have presumed that Senior Managers were responsible for an alleged breach falling within their area of responsibility, unless the Senior Manager could satisfy the regulators that they took "reasonable steps" to prevent or stop the regulatory breaches occurring or continuing. This was altered in 2016 to place the burden of proof back on the regulator – essentially taking us back to the rules which existed prior to and following the financial crisis.	Before the relevant provisions had come into force

# Failing to hold senior executives to account for misconduct

Another consistent theme are constant promises made by politicians and regulators that senior executives of firms will be held accountable for scandal and misconduct. Regulators and politicians have been promising this for over 300 years – without much success. Indeed the situation has got worse. After the failure of City of Glasgow bank in 1878 the directors were all given prison sentences. When Barings collapsed in 1995 it was widely perceived that senior management had evaded responsibility – this was despite the fact that 10 members of senior management were fined, banned from working in the City or acting as directors of a company.

After the FSA was established in 2001, Howard Davies promised that the regulator would introduce a system where 'specified individuals at the top of the firm have clearly set out responsibilities for risk management and compliance, for which we hold them accountable.' But when the major banks collapsed the public were told that responsibilities weren't properly defined and that there was an 'accountability firewall' protecting the directors and senior executives. More people were sanctioned following the failure of Barings than for the incompetence and misconduct in HBOS, RBS and Northern Rock combined. Mistreatment of consumers and small businesses also continued to go unpunished. The only senior executive fined by the FSA for the £38 billion PPI mis-selling scandal was the Chief Executive of sofa shop 'Land of Leather'. Not a single banking executive was subject to any enforcement action for the mis-selling of PPI to consumers or interest rate swaps to SMEs.

## Action taken against individuals following financial scandals

Name of Scandal	Nature of Misconduct	Action taken against individuals	Nature of punishment
South Sea Bubble (1720)	Stock market manipulation; insider trading; keeping false accounts; fraud and bribery.	Directors and politicians were prosecuted.	Directors were imprisoned in the Tower of London and had their assets confiscated. <sup>13</sup> 33 directors were fined the equivalent of more than £3 billion today. The Chancellor of the Exchequer was expelled from the House of Commons and imprisoned in the Tower of London.
1825 Banking Crisis / Poyais	Created fake South American country and used the London Stock Exchange to sell fake Poyaisian bonds.	Gregor MacGregor and 3 other directors were prosecuted for fraud.	Gregor MacGregor and 2 other associates were acquitted. One other associate was convicted of making false representations and given 13 months in prison. <sup>14</sup>
Overend and Gurney (1866)	Bank collapsed following lending to the railway industry. Fraud and false statements.	Directors prosecuted at the Old Bailey.	Acquitted as Judge said they were guilty of 'grave error' rather than criminal behaviour.

Name of Scandal	Nature of Misconduct	Action taken against individuals	Nature of punishment
City of Glasgow Bank (1878)	Bank collapsed following lending to people described as 'gangs of desperate adventurers'; falsified its accounts; share price manipulation.	Directors prosecuted at the High Court in Edinburgh.	Bank's general manager and one director were given 18 month prison sentences. Five other directors were given 8 month sentences. <sup>15</sup>
Secondary Banking Crisis (1973-75)	Falling property prices led to the bail-out of around 60 banks by the Bank of England.	Jim Slater was prosecuted under the Companies Act. Directors of London and County Securities prosecuted for false accounting, forgery and theft.	Mr Slater was convicted and fined £150. One Director of London and Country Securities was given 2 years in prison and the others were fined or got suspended sentences. <sup>16</sup>
Norton Warberg (1981)	Investment fraud and conflicts of interest.	Andrew Warberg fled to Spain but was charged on his return in 1987.	Andrew Warberg was sentenced to 3 years in prison. <sup>17</sup>
Johnson Matthey Bank (1984)	High loan growth leading to concentrated exposures to a small number of customers; misreporting to the supervisory authority. <sup>18</sup>	Directors were investigated as there was "strong suspicion of corruption". No action was taken as misreporting to the supervisory authority was not an offence. <sup>19</sup>	No punishment for the directors.  Customers were jailed for theft and lying to an inquiry into the bank's collapse.
Barlow Clowes (1988)	Investment fraud.	Peter Clowes was charged with fraud and theft.	Mr Clowes was sentenced to 10 years in prison.
BCCI (1991)	Money laundering; fraud and terrorist financing.	Senior executives were charged, but were never brought to trial.	No punishment, but some cases were settled by payments to the US authorities.
Barings (1995)	Rogue trading; false accounting and poor risk management.	Nick Leeson was charged in Singapore. DTI and SFA took action against directors and executives.	Nick Leeson was imprisoned for 6 years in Singapore. 10 Barings directors and senior executives were disqualified from being directors for up to 6 years.
Pensions Mis-selling (1990s)	Mis-selling of personal pensions.	No action was taken against senior executives.	None.

Name of Scandal	Nature of Misconduct	Action taken against individuals	Nature of punishment
Equitable Life (1999)	Potential payments to policyholders were under-funded; management team were accused of 'dubious' practices and nurturing a 'culture of manipulation and concealment'.	Non-executive directors were subject to private legal action.  FSA investigated the role of executives.	Directors escaped punishment and did not pay any money in settlement of a private action by Equitable. The Appointed actuary was banned by the FSA from working in the financial services industry for 6 years. Roy Ranson escaped sanction by the FSA but was thrown out of the Institute of Actuaries.
Split-Capital Investment Trusts (2002)	Mis-selling of split-capital investment trusts; market abuse; cross holdings; excessive gearing.	FSA investigated a number of individuals.	4 individuals voluntarily agreed to not perform certain functions in the industry for periods ranging from 6 months to 2 years. The FSA said that it had "not made any findings of regulatory breach against them and the...individuals have not made any admissions". <sup>20</sup>
PPI Mis-selling (2000s)	Mis-selling of Payment Protection Insurance.	FSA investigated a number of firms.	No senior executives at major banks have faced sanctions but the FSA did fine the CEO of sofa shop 'Land of Leather'.
Northern Rock (2007)	High risk business strategy reliant on wholesale funding; irresponsible lending leading to taxpayer bail-out of Northern Rock.  Misreporting mortgage arrears statistics.	FSA investigated but apart from action taken for misreporting of arrears, no other action was taken against directors or senior executives.	For misreporting of arrears data: Andrew Jones was banned for life from the financial industry and fined £320,000 by the FSA. <sup>21</sup> David Baker was banned and fined £504,000. <sup>22</sup> Richard Barclay was banned and fined £140,000.
HBOS (2008)	High risk business strategy; Irresponsible lending; exposure to property and poor culture led to taxpayer bail-out of HBOS. <sup>23</sup>	FSA investigated Mr Cummings but failed to investigate any other directors or senior executives. <sup>24</sup>	Peter Cummings was banned for life from the financial industry and fined £500,000. <sup>25</sup> Sir James Crosby returned his knighthood.
RBS (2008)	Inadequate capital; poor judgement and due diligence around the ABN Amro takeover; credit and trading losses led to taxpayer bail-out of RBS.	FSA investigated RBS's investment banking division, the takeover of ABN Amro and conduct around the 2008 rights issue.	Jonny Cameron voluntarily agreed to no longer work in the financial industry. The FSA did not make any finding of regulatory breach against Mr Cameron. <sup>26</sup> Sir Fred Goodwin lost his knighthood.

# What went wrong with the culture of the FSA and the Bank of England?

The most crucial lessons are that it is not just what regulators do directly after a crisis that matters, but how they hold onto the lessons they learned and ensure that they continue to guide their actions. In the run up to the financial crisis responsibility for financial regulation and stability lay with the FSA and the Bank of England. It is important that regulators learn from their mistakes so as part of our research we examined the issue of what went wrong with the culture of the FSA and Bank of England. This is an issue we have examined as part of the work of New City Agenda over the past year, including through the lectures we have hosted by Professor Anat Admati, John Kay, Martin Wolf, Rhydian Lewis and Antony Jenkins. We also reviewed a wide range of documents into the financial crisis and discussed this issue with a variety of former staff, politicians, and industry and consumer stakeholders. Our research highlighted the following cultural issues at the financial regulators which contributed to the 2008 financial crisis.

- **Regulatory architecture/structure:** A single regulator which covered consumer protection and financial stability was simply too big to work effectively. It was a challenge dealing with a vast bureaucratic organisation. There were too many diverse objectives which actually required different sets of skills, cultures and approaches. The Board of the FSA would be talking about the Eurozone crisis one minute and the next minute talking about small Independent Financial Advisers (IFAs) and mortgage brokers. The scope of the FSA was expanded to include more small businesses without a commensurate increase in resources. Responsibility was not properly defined and no one seemed to be 'in charge' of the tripartite system. This led to a culture of not challenging firms or considering what would happen in a worst-case scenario.
- **Regulatory philosophy and culture:** The culture of the FSA was far too permissive. The FSA would only intervene when there was overwhelming evidence of failure. It was reactive rather than proactive. There was a group think problem and a lack of internal/external challenge. There was belief that senior managers in firms would act in the best interests of customers and shareholders. The regulator was seen as a referee rather than as an agent of consumers – it had a desire to upset everyone to demonstrate it was doing a good job.
- **Regulatory approach:** The reactive and permissive culture drove the regulatory approach. There was a lack of will to intervene in the operation of markets and to intervene in big firms. The FSA did not want to be seen as interventionist by politicians. It was a very internally focused organisation – a lot of Board time and overall activity was focussed on the inside - on making the organisation work. It lacked an overall strategy and never tried to define what success looked like. There were ideological presumptions – people within the regulator really believed that markets would deliver for consumers and that even for extremely profitable products such as PPI, the market would encourage firms to have high standards of consumer protection. There was a touching naivety – a naïve faith that markets would discipline banks with risky business models and ensure that they were safe.
- **FSA had a culture of box-ticking and was focussed on processes rather than outcomes.** This was despite the significant emphasis which senior management at the FSA made on the move towards principles-based regulation. It failed to challenge the industry and was more comfortable examining

processes – such as how many staff could name the six treating customers fairly outcomes – rather than what was actually being delivered.

- **Unwillingness to challenge global standards on capital:** The FSA & Bank of England were part of a global trend towards lower levels of capital through the introduction of the international Basel 2 standards. They also had an insufficient focus on liquidity and did not realise (or did not see it as a problem) that UK banks were heavily dependent on wholesale markets.
- **The ‘tone from the top’ was that the FSA should not be an enforcement-led regulator:** The FSA was a weak enforcer – there was a culture which said that the FSA was not an enforcement led-regulator. Fines were too low and individual executives were let off the hook.
- **FSA relied too much on disclosure of information to consumers:** It responded to too many issues by writing and re-writing rules on how information was disclosed to consumers. It thought that relying on disclosure of information was an appropriate method to use rather than considering more robust intervention such as banning toxic products such as PPI.
- **FSA failed to examine the business models of banks – it did not “follow the money”:** The FSA didn’t understand how banks made their money or what impact this might have on their resistance to regulatory change. The FSA said that it was not a price regulator which seemed to indicate that it was uninterested in the value-for-money of various financial products or the lack of competition in various markets.
- **Political pressure on the FSA for “light touch” regulation influenced its culture:** The FSA was under industry and political pressure to “cut back” red tape and regulation and take a light-touch approach. CEOs had a manifesto of reducing the weight and size of regulation.
- **FSA and Bank of England placed insufficient emphasis on systemic stability.** The Bank of England issued a few sermons but didn’t take any action. The Bank failed to see the build-up of risks and “group think” meant that there was little challenge to prevailing orthodoxies. It believed that the UK banking system was far more resilient than in the past. The Bank failed to understand that the UK mortgage market relied on unstable wholesale funding.
- **Bank of England tried to avoid responsibility for ensuring financial stability:** By making excuses that it lacked powers to do anything about financial stability the Bank allowed a narrative to develop that it hadn’t done anything wrong and didn’t need to change. Prior to the financial crisis the Bank did not view the developments in the financial system such as growing credit and complexity as posing extra risk.

## Regulatory responses to the 2008 financial crisis

The financial crisis of 2008 was a significant challenge to the UK financial regulatory landscape. It stretched the regulators to their breaking point. It showed up some significant shortcomings and led to a fundamental rethink of how the financial industry was regulated. The result was the foundation of the Prudential Regulation Authority, which became a subsidiary of the Bank of England and the FSA transforming itself into the Financial Conduct Authority. A new Financial Policy Committee (FPC) was established in the BoE to protect and enhance the resilience of the financial system.

There was a fundamental rethinking of the approaches to regulation. New regulators claimed that they would be more proactive, rely on judgement rather than box-ticking and take strong enforcement action against firms and individuals which breached requirements. They said that they would hold senior executives to account for poor conduct and allow mismanaged firms to fail. Senior management at the regulators explained these new approaches – but, in some areas, their statements were very similar to those made on the introduction of the FSA.

## New structures, new powers and new objectives

The reforms gave regulators new structures, new powers, new objectives and new governance arrangements. Less attention was initially paid to changing the culture of these organisations. The FCA introduced a set of cultural values. The Bank of England launched its One Bank programme in 2014. We will look into these culture change initiatives in more detail in the following chapter.

Following the establishment of the FCA, PRA and FPC in April 2013, their activities have continued to evolve. In 2014, the FCA took over the regulation of consumer credit from the Office of Fair Trading. This increased the number of firms regulated by the FCA from around 27,000 to well over 70,000. Two-thirds of the FCA's total regulated population now conducts consumer credit activities.

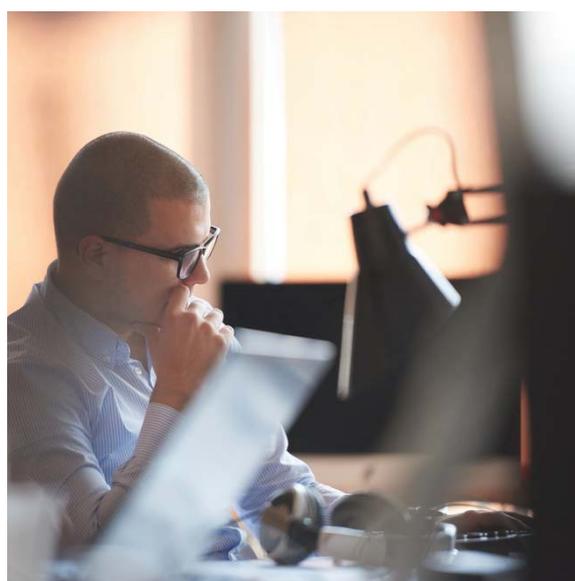
### The 'Tone from the Top' in the UK's financial regulators – big similarities between the FSA and the FCA/PRA

The 'Tone from the Top' is seen as a key driver of an organisation's culture, but the bold claims made in speeches and statements are not enough to drive a change in culture. On the establishment of the FCA and the PRA, senior management made a wide variety of comments and speeches – setting out the new approach which the regulators would take. Many of these statements were actually very similar to those made around the year 2000 by senior executives at the FSA. Just like banking, this shows that changing the tone from the top alone is not enough to ensure a change of culture – cultural change is lost in the middle and fails to reach the frontline or make a difference to the way the regulator operates. In a regulator the 'tone from the top' needs to be translated into behaviours and make a real difference to how those on the frontline do their job. It needs to be translated into clear processes and be made a key part of remuneration and performance management schemes. Regulators started out with the best of intentions to hold senior executives accountable – but they failed to put in place the culture in the regulator to make sure that this happened.

# Similar Statements made about the regulatory philosophy - FSA and FCA/PRA

Subject	FSA	FCA / PRA
Senior Management Responsibility	<p>"Regulators have tended to find it difficult to pin clear duties on chief executives. There have been cases where a highly legalistic approach on their behalf to the responsibilities they consider themselves to have allowed them to escape, when a commonsensical view would argue that they must surely have had some responsibility for ensuring that the business was controlled in a way which prevented either its customers being unreasonably exploited, or indeed its shareholders money being put unreasonably at risk"</p> <p>"When things go wrong, we shall look directly to senior management, whom we shall hold accountable....Now we have a system of personal registration, where specified individuals at the top of the firm have clearly set out responsibilities for risk management and compliance, for which we hold them accountable."<sup>27</sup></p>	<p>"[This] brings us towards a system where individual responsibility becomes both clearer and more immediate. There will be more existential pressure, if you like, on leaders."</p> <p>"It also, crucially, moves us away from this position where determining who is accountable for what, has required often enormous powers of regulatory decryption. Indeed, there are cases where it's taken weeks, if not months...to determine line management responsibilities."<sup>28</sup></p>
Box-ticking	<p>"Our philosophy is one of trying to work smarter, we think it is consistent with the approach we are setting out today, that we want to be a more analytical, thinking Regulator, we want there to be less box checking and routine activity"</p> <p>"the content of those discussions will also change, away from investigation of whether evidence exists to demonstrate compliance with specific rules to discussion of broader issues and of desired outcomes: in short, a move away from what is normally characterised as "box ticking" – the comfort zone for both regulator and compliance functions."<sup>29</sup></p>	<p>"Too often our response was overly reliant on regulation by rote. We built ever more rules and guidance about how to build a compliant process. It was robotic...In actual fact, in many cases – like PPI – tick-box regulation simply encouraged a tick-box service. Leaving firms with often huge clean-up bills and badly damaged brands."<sup>30</sup></p> <p>"a new philosophy of regulation. Not regulation through the rear-view mirror – but forward-looking regulation. Not regulation based on historic data collection but much more real time. Not box-ticking regulation, but regulation based on judgement."<sup>31</sup></p>
Competition	<p>"We take the view that promoting competition can be an important way of achieving our regulatory objectives. In particular, we see great value in transparency, so that better informed consumers can take better investment decisions."<sup>32</sup></p>	<p>"We want to ensure that a competitive financial services market works for the interests of consumers, with adequate protections in place."<sup>33</sup></p> <p>"We believe that, through better competition, consumers will benefit from better choice. Not just choice of provider, but choice of products, of services, of channels. And that these choices will create a virtuous cycle where innovators encourage fast followers amongst market incumbents, which in turn encourages more innovation and competition in the interests of consumers."<sup>34</sup></p>

Subject	FSA	FCA / PRA
Too-Big-To-Fail	<p>"Given the nature of financial markets, which are inherently volatile, achieving a "zero failure" regime is impossible and would in any case be undesirable. Any such regime would be excessively burdensome for regulated firms and would not accord with the statutory objectives and principles set out in the Act.... Considerable dangers would arise if consumers or market participants believed that no firm would ever be allowed to collapse; this would reduce the incentive for individuals or firms to take due care in assessing the risk attaching to their financial decisions." <sup>35</sup></p>	<p>"The system "will move us away from a world in which the job of the supervisor is to crush the probability of failure, come what may." <sup>36</sup></p>
Toxic / complex products	<p>"These transfers [of credit risk] have taken more exotic forms, such as Collateralized Debt Obligations (CDOs) or indeed synthetic CDOs. One investment banker recently described synthetic CDOs to me as "the most toxic element of the financial markets." <sup>37</sup></p>	<p>"Both complexity and interconnectedness obscure investors' understanding of the level and distribution of risk across the system, even if there is a reasonable degree of disclosure — which is often not the case. The resulting opacity of financial instruments can be a source of systemic risk in itself." <sup>38</sup></p>





## Culture and cultural change in the UK's financial regulators

The foundation of PRA and FCA was based on a recognition that there had been a range of failures in regulators' responsibilities, powers and governance mechanisms. It took longer to acknowledge that the culture of the regulators also needed to change. In this chapter, we look at how the PRA and FCA sought to change their culture. We will explore the background to cultural change in each regulator, the kind of culture they are trying to create and the methods they are using to do this. We consider employees responses to this cultural change. Finally, we look at some common themes which run across each of the change initiatives in the regulators.

# Overview of cultural change programmes

## Bank of England / PRA – corporate style, top-down cultural change programme

We find that the Bank of England and the PRA have developed and started to implement a detailed plan for cultural change. It articulated some core goals and cultural values. It has launched a programme similar to what you might find in many private sector organisations involving the introduction of a Code of ethics and shifts in remuneration structures, measurement, hiring, talent development and collaboration. The Bank held an Open Forum to discuss the future of financial markets. A new Oversight Committee was introduced although this was then abolished. An Independent Evaluation Office was also introduced to keep the Bank's performance under review. There has been some push back from longer serving staff members and it was not yet clear that the initiative was having a significant positive effect on frontline staff. Overall the cultural change initiative seems to be proceeding relatively smoothly. From our discussions with various stakeholders, it appears that the PRA was becoming increasingly integrated within the BoE.

## FCA – a fragmented approach to cultural change

The FCA took a more fragmented approach and did not have a comprehensive programme of cultural change in place. Its senior leaders introduced new values and made a number of speeches emphasising the need to adopt a new culture and approach – which was characterised by those outside the regulator as 'shoot first, ask questions later'. It made changes to hiring, training and remuneration systems but was not clear on what it was trying to achieve or how progress should be measured. Staff said that there are positives at the FCA including a friendly environment, high quality staff and many learning opportunities. There are also negatives include staff turnover, overload and external pressure and bureaucracy. There seemed to be an overarching concern that while Martin Wheatley had galvanised staff, there was a danger of back-sliding. Events around the Davis review, the perceptions of political interference and the removal of the CEO meant that the FCA was blown off course and risked not achieving its objectives.

# Bank of England / PRA

## The One Bank Strategy

One of the main drivers of making the PRA part of the BoE was culture.<sup>39</sup> When the PRA became a subsidiary of the bank, it was hoped that it would 'benefit from the Bank's judgement-driven culture'. This was challenging as many of the key people in this new organisation had come from the FSA, and presumably had been imprinted by the culture there.

Following the foundation of the PRA the Governor of the Bank of England, Mark Carney, announced the 'One Bank' initiative.<sup>40</sup> At the heart of this was the plan to develop a common culture in both of the organisations. The initiative established a renewed mission for the Bank – 'Promoting the Good of the People of the United Kingdom by maintaining Monetary and Financial stability'.

The *One Bank* strategy focused on the Bank 'maximising our impact by working together'. It brought together aspects of central banking previously dealt with separately such as macroprudential supervision, microprudential supervision and monetary policy. There are four central pillars of this One Bank strategy: (1) diversity and talent, (2) analytical excellence, (3) Outstanding execution, and (4) openness and accountability.

The 2015 BoE annual report outlined progress on the *One Bank* plan. This included harmonising staff terms and conditions, implementing a new talent strategy, embedding targets for diversity, and creating an integrated research function. Efforts were made to increase transparency and an international directorate was created. A central aspect of the *One Bank* strategy had been to establish a similar culture across the bank. The *One Bank* strategy aimed to be 'much more than a 'to do' list of major projects'. It was hoped it would lead to 'fundamental shifts in the Bank's culture and thinking'

## Values at the Bank of England / PRA

The *One Bank* strategy states the values which underpin the culture of the Bank of England. These values should provide the basis to measure employees' performance. The five core values are:

**1. Collaborative.**

We are committed to working together to ensure our best possible contribution to the public good. We share information, skills and expertise freely.

**2. Inclusive.**

We actively encourage challenge and divergent views, and create an environment where all staff can speak up, share their views and influence outcomes.

**3. Empowering.**

We expect initiative-taking, creative thinking and rigorous analysis in all areas. To achieve this, we will clearly delegate suitable responsibility and accountability for analysis, recommendations and decisions.

**4. Decisive.**

We support decisive action grounded in policy. We will create an environment that is agile, where all staff can respond swiftly to changing priorities, with a focus on delivery.

**5. Open.**

We encourage open debate as the most constructive way to resolve conflicts. And we ensure that communication is open and transparent in discharging our duties in pursuit of our mission.

# Mechanisms for Developing One Bank Culture

To foster the One Bank culture, the Bank and the PRA put in place a range of mechanisms.

## Competence Development

The Bank sought to develop staff competencies to deliver the judgement-based, forward-looking supervisory approach. This has involved career development for all staff, succession planning, a greater emphasis on diversity and inclusion, and the development of a graduate qualification in central banking which was launched in conjunction with Warwick Business School in 2015.

## Remuneration

**Harmonisation.** There has been an ongoing attempt to harmonise the reward systems in the PRA and the rest of the Bank. Ex-FSA and BoE staff were moved onto similar contracts. The PRA developed a remuneration scheme to attract and retain a mixture of talent at all stages of their career. Staff at the Bank and PRA receive both pension benefits and performance related-pay.

**Bonuses.** In 2013/14, bonus payments for individual performance were made to Executive Directors, other senior executives and staff on Bank terms from a pool of 6% of relevant base salaries; in the case of those still on FSA terms the pool was 11.25%. In 2014/15 the bonus pool was 6% of salary for Bank staff and 15% for FSA staff. From 1st April 2015 all bonuses will be paid from a pool worth 10% of salary. It is not clear whether any element of bonuses are deferred – as the PRA requires for senior executives in firms – or whether it is subject to clawback or malus in the event of material failures or poor performance.

**Pensions.** The Bank operated a defined benefit pension scheme. The final salary scheme is closed to new members, but the career average scheme is still open – with contributions worth around 30% of salary. Staff transferred over from the FSA to the Bank/PRA were initially members of a defined contribution scheme. Following the changes, all staff were placed in the career average pension fund. Those who had transferred over from the FSA accrued benefits at a lower rate.

## Hiring

**Recruitment and retention.** Retaining existing talent and hiring new talent is at the forefront of the PRA's concerns. Staff turnover at the PRA is higher than the rest of the bank (10.6% compared to 8.7%). A survey of exit interviews completed in November 2013 identified the transition to the Bank, limited or unclear advancement opportunities within the Bank, a hierarchical culture and pay as being the major reasons for leaving the PRA.

## Performance Management and Promotions

**Mobility.** Internal promotions and staff mobility across the Bank/PRA were encouraged. There is clearly significant mobility in the PRA. During 2014, 13% of PRA staff received a promotion and 23% moved role.

**Learning.** There is a modular learning framework at the Bank. New entrants are put through appropriate technical training. The new qualification in central banking provides a common technical basis for staff.

**Code of Ethical Standards.** Following a review of ethics and conduct in the Bank, a new enhanced Code applying to all employees covering these policies and rules was developed which sought to 'capture the essence of what it means to be in public service at the Bank.' The Code provides a statement about the behaviours colleagues, counterparties, stakeholders and the public should expect from employees at the Bank. All employees will be required to attest on annual basis to their familiarity with the Code, and their observance of it. To support this initiative, the Bank is establishing a central compliance function, which will work with management to embed the approach in terms of both understanding of, and compliance with, the Code. It is not clear how the Bank will report on issues raised regarding possible breaches of the Code and any specific occasions where it has been breached.

**Speaking Up.** Earlier inquiries into failings at the BoE during the financial crisis identified lack of escalating concerns upwards. The Bank has introduced a 'Speak Up' policy enabling employees to raise concerns they may have about disregard of Bank policies and codes, a risk to the Bank, malpractice or misconduct. The PRA also provides whistleblowing facilities for individuals within the financial institutions which it supervises.

## Challenge

**Practitioner Panel and Consultation.** The PRA has a statutory duty to maintain effective arrangements to consult practitioners and consider their representations. It is also required to establish the PRA Practitioner Panel to represent the interests of practitioners. Members are appointed by a number of trade associations including the British Bankers Association, Association of British Insurers, Building Societies Association and the Investment Management Association. The PRA seeks input from firms on the effectiveness and quality of its supervisory framework and approach through individual feedback from firms to their usual supervisory contact; industry events and forums; the PRA's consultation process; and engagement with the PRA's Practitioner Panel. The PRA also asks firms to complete an annual feedback survey. In 2014/15, 'Overall, the





feedback suggests that the majority of respondents have a positive view of the PRA (93% of respondents either agreed or strongly agreed that they have an effective relationship with the PRA).<sup>41</sup>

There are no requirements for the PRA to consult academics, consumer groups or the public. The PRA is not required to formally consult the FCA Consumer Panel, although the Consumer Panel does have the right to communicate its views to the PRA.

**Independent Reviews.** The Bank commissioned a number of independent reviews. These have included reviews of the transparency arrangements for monetary policy, its forecasting performance, its provision of liquidity during the financial crisis, its framework for providing liquidity to the banking system, the failure of a major payment system and its knowledge and involvement into manipulation of the foreign exchange market. These have been undertaken by bankers, ex-central bankers and the former Chairman of Arcadia Lord Gribner QC.

**Evaluation Office.** The Independent Evaluation Office (IEO), established in September 2014, supports the Court in discharging its statutory obligations to keep the performance of the Bank under review. It operates at arm's length from the business areas of the Bank and is staffed by a small, permanent secretariat headed by an Evaluation Director reporting directly to the Chairman of Court. The IEO undertakes one-off assessments as well as regular reporting to Court on the performance of the Bank's policy areas and strategy. The IEO has recently undertaken an evaluation of the PRA's approach to implementing its competition objective.

**Staff Blog.** Bank Underground is a new blog written by staff at the Bank of England. The blog was launched as part of the Bank's Strategic Plan which called for a new publication giving insight into topical issues from a staff perspective rather than that of the MPC, FPC or PRA board. On Bank Underground, authors write in an individual capacity and there is no 'house view'. Some posts broadly accord with the Bank's official views or provide further underpinning for them. Other posts differ from the Bank's official position and the external consensus.

**Open Forum.** The Bank of England Open Forum was held on 11th November 2015. It was held to take stock of reforms and discuss the future of markets. It brought together policymakers, financial market participants and users, academics, media representatives and wider society. This included discussions about the role of financial markets in the economy, the impact of regulation and building a social licence for markets. The Bank concluded that it and others had a 'responsibility to explain clearly to the public what we are doing to make financial markets better serve the needs of society so everyone can enter into the debate.' This would involve talking and listening to the public so that the Bank understood their needs and challenges as consumers. The Bank also committed to talking and listening to a broader set of stakeholders across society when it designs and implements policy.

**National Audit Office.** Historically the Bank of England has been outside the scope of the NAO. The new Bank of England Act brings the Bank within the scope of the NAO so that the NAO can conduct value for money studies of the BoE and the PRA. However, the NAO has its ability to do this restricted in that it cannot examine policy decisions taken by the Monetary Policy Committee (MPC), FPC or the Board of the PRA. It also cannot examine supervision decisions relating to payment systems, settlement systems or clearing houses.

## Leadership

**Senior Managers Regime.** The Bank intends to apply the core principles of the Senior Managers Regime (SMR) to its own senior managers. In line with PRA rules the principles of the SMR will apply primarily to the Governor and Deputy Governors, the Chair of Court, and members of Court who chair certain operational committees. The Bank will map how the Bank's responsibilities are discharged, and allocate responsibilities to individual senior managers. These maps will be published. It will also describe and publish its governance structure. The Bank will also 'take a rigorous approach to senior managers' suitability including having a 'robust' appointments process, assessing ongoing suitability of senior executives for their role annually and improving the induction package to ensure that new senior managers fully understand their responsibilities.

**Governance of the Bank of England.** The Bank's Court of Directors acts as a unitary board, setting the organisation's strategy and budget and taking key decisions on resourcing and appointments. Required to meet a minimum seven times per year, it has four executive members from the Bank and up to nine non-executive members. Subject to the activities which are reserved by statute for the MPC, FPC and PRA Board, Court is responsible for managing the Bank's business, and where appropriate it may delegate as it sees fit. The Court has a majority of independent non-executive members and an independent non-executive Chairman. Non-executive members of the Bank's Court also regularly met without executive members, both informally and in the form of the Oversight Committee of the Court and have the right to commission reviews into the Bank's performance. The Oversight Committee has been abolished and the number of non-executive members on the Court is being reduced from nine to seven.

**Governance of the PRA.** The Board of the PRA is chaired by the Governor and includes four Bank of England staff, the CEO of the FCA and six external members. The external members currently include ex-banking and insurance executives, management consultants and lawyers. The Bank of England Bill will replace the PRA Board with a Prudential Regulation Committee (PRC), which will take decisions about the PRA's rules, policies and supervision. However, the PRC will no longer take decisions on issues such as staff terms and conditions, recruitment and IT. Members of the PRC will be appointed by the Chancellor, rather than the Court with the

approval of the Treasury. A review of the PRA Board's effectiveness by the Chairman of the Bank's Court found that 'Overall, the Board was seen to be working well'. Three main areas for improvement were identified: the measurement of the PRA's performance against objectives; talent management and succession planning; and the volume of material on Board agendas. PRA Board members can continue to hold senior positions in regulated companies, although currently none do so. External Board members are dominated by those with banking and insurance experience.

## Measurement

**Organisational Performance.** The PRA keeps track of (1) employee turnover, (2) breaches of the Memorandum of Understanding with the FCA (3) an annual feedback survey of regulated firms, (3) the number of complaints (4) complaints received by the Complaints Commissioner and (5) attendance at Board meetings. None of these metrics directly measure culture. It is also difficult to identify clear and objective outcome measures for the PRA and the BoE. This means the organisation has to rely on a range of metrics to track its over-arching performance.

**Individual Performance.** The performance of staff has a clear link to reward and is based on staff meeting objectives aligned with the Strategic Plan as well as peer reviews whereby staff assess their own performance and that of those around them. Behaviours would be a critical part of the review.

## Collaboration

**Collaboration with Industry.** The PRA collaborates by gathering individual feedback from firms, attending industry events and forums, a wider consultant process and engagement with the PRA's practitioner panel. The PRA holds briefings for small groups of firms to emphasise regulatory activity. 93% of industry respondents to the PRA's survey agreed or strongly agreed that they had an effective relationship with the PRA.<sup>42</sup>

**Collaboration with other regulators.** There was also some evidence of collaboration within the regulators such as three joint meetings between the PRA board and the FPC. The annual report points out that 'the PRA continued to work closely with the FCA across a range of supervisory and policy matters'. There continues to be some shared IT systems between the PRA and the FCA.

## Staff Responses

**Mixed Responses.** A survey of staff at the bank as a whole showed there was some degree of trepidation about the *One Bank* initiative among longer staying staff.<sup>43</sup> A National Audit Office report found that a more judgement based approach has meant that decisions are being taken at more senior levels. This has reduced supervisors 'own decision-making and motivation'. The Bank's own staff survey showed that staff are proud to work for the Bank, it is strong on teamwork and collaboration, managers acting on people's suggestions and the Bank's overall performance on delivering its mission. The most negative responses were to questions about performance evaluation, reward, communications with staff and barriers to staff doing their job well. One of the least favourable answers was also given to a question about the Bank's strategic plan: Only 35% of staff gave a favourable answer to the question '*Based on my recent experiences, the Bank's Strategic Plan and initiatives are having a positive impact on the way we work*' with 21% giving an unfavourable answer and 40% neutral.

# Growing complexity of regulation

The FCA and the PRA now have rulebooks, guidance and supervisory statements of over 13,000 pages, an increase from 8,000 in 2007. This figure probably under-estimates the increase as the PRA moved to a smaller font size for its rulebook. To buy a printed copy of the FCA rulebook now costs £3,641, the same as a second hand *Mini Cooper*.

This growing complexity of regulation, particularly as it becomes closer to implementation is not unique to the UK. In the US, The Volcker Rule – which aimed to prevent banks from engaging in proprietary trading - went from a three-page memorandum by Paul Volcker, to 11 pages of the Dodd-Frank Act, and then to over 900 pages of regulation and commentary on the Volcker rule in 2013.<sup>44</sup>

Standards concerning the amount of capital banks need to hold have also become far more complex. The first Basel Accord, Basel I, consisted of 30 pages. Its revision in 2004, Basel II, had expanded to 347 pages. The last revision in 2010, Basel III, covers 616 pages, twice as big as Basel II, and more than twenty times as big as the original accord of 1988. The application of these requirements has also increased in complexity. Initially, Basel I had five risk categories for the calculation of the risk-weighted capital of a bank. Under Basel II and III, this increased to more than 200,000 risk categories for a large bank. A comparable evolution is that of the number of calculations to be made by a large bank to determine its risk-weighted capital. This number increased from a few calculations under Basel I to more than 200 million calculations under Basel III.<sup>45</sup>

In addition to growing detail of rules, the regulators supervisory approach became more detailed. An assessment by the FSA of the prudential and conduct risks in a bank, known as an Advanced Risk Response Operating frameWork (ARROW) assessment, became extremely resource intensive. It could involve up to 130 interviews and a broad Risk Mitigation Plan would be developed, with the points ticked off a long list with little consideration of whether they had been addressed effectively.

## Drivers of complexity

There were several drivers of this increasing complexity. Among firms there was a desire for certainty about the standards. Regulators also prefer more detailed rules as this gives staff clearer standards to apply, makes it easier to challenge non-compliance and also demonstrates regulatory activity. Others we spoke to noted that we had given regulators very difficult tasks. For example, designing a letter which encouraged consumers to shop around for retirement income products was an almost impossible task. Writing and constantly re-writing these sorts of disclosure documents every few years was resource intensive, but there was no evidence it generated any improvements to competition.

## Distortions to competition

Growing complexity in regulation also constitutes a barrier to entry into the banking sector. The

compliance costs associated with the laws and regulations are often sunk costs. Higher sunk costs reduce the incentive for entry into the market. By creating economies of scale, these higher fixed costs create an unequal playing field between small entrants and existing large players.

Larger banks and institutions have a close and continuous relationship with the regulator. This can also distort competition. The largest banks and other institutions have teams of people within the regulators they can use to test ideas or to ask questions. Smaller banks and institutions do not have the same access. For example we were told that if the CEO of a medium sized institution wants to ask the FCA a question then they have to ring the call centre.

## Problems from excessive complexity

Those who spoke at New City Agenda's lectures also noted some of the problems from excessively complex regulation:

*"Complexity...opens up more ways to obscure the flaws of the regulations from the public and creates the pretence of action even if regulations are ineffective."*<sup>46</sup>

– Professor Anat Admati

*"A great deal of complexity of modern finance is [to exploit complexities in the regulatory system]. We try to lay down rules from the centre. These have unintended consequences and markets develop in order to circumvent or mitigate the impact of these rules. We then construct more complex rules to try to deal with it and that process goes on and on forever, and it goes on in a way that is more and more complicated and less and less effective. In truth, if that kind of structure would have worked the Soviet Union would have worked"*<sup>47</sup>

– John Kay

*"Incoherent conglomerates have spawned fiendishly complex regulation which creates a barrier to entry and is a dead-weight cost: like a bindweed, it strangles value and entrenches sometimes surreal and unnecessary complexity. The provision of different services – some core utilities; some discretionary risk businesses – results in a form of regulatory capture with the valid pursuit of risk becoming a prisoner of its bedfellow, certainty."*<sup>48</sup>

– Rhydian Lewis, CEO RateSetter

## The future

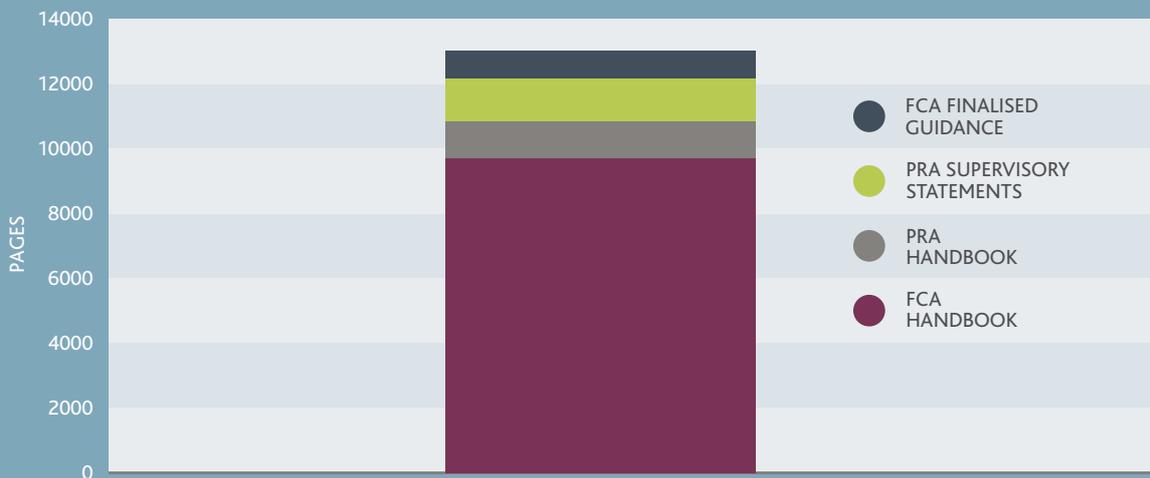
Some in the industry and regulators wished to return to an earlier era when supervision would be based on high-level discussions between firms and regulators. Banks would respond to the points raised, respected the regulators and would not ask for justification in the form of detailed rules. Some said that the environment had changed and that banks and their armies of lawyers would be willing and able to challenge everything that wasn't codified. Others have noted that rules are necessary to ensure consistency across different institutions. Whilst many in the financial services industry have called for simpler regulation few had concrete suggestions of how it could be

achieved or particularly costly regulations they would like to remove. Whilst saying they were in favour of principles, some in the industry showed a stubborn attachment to particular rules.

Indeed, some stakeholders we spoke to pointed out that it was not only the regulator which had a culture of box-ticking. Too many firms also had a culture of box-ticking, which saw regulation as the only guide to acceptable behaviour. Firms responded to ever more complex regulation by engaging in gaming to operate within the letter, not the spirit of the rules. This led to waves of ever more complex regulation and detailed box-ticking supervision.

What many respondents agreed on was that moving to a less complex regulatory system will inevitably involve giving more discretion to regulators. This will require a change in the culture of the regulatory organisations – where currently hierarchy and conformity are more valued than judgement and individuality.

## Length of FCA/PRA rules, guidance and supervisory statements



## Financial Conduct Authority

### Background – Shoot First, Ask Questions Later

**New Culture.** Following the creation of the FCA, senior leaders claimed that they would seek to significantly change the regulator’s culture. It was hoped they could make the FCA more proactive, transparent and consumer-focused in its approach. It would develop a ‘judgement based’, ‘forward looking’ and ‘forward thinking’ approach. There was the intention for the FCA to be more proactive – characterised as “shoot first, ask questions later” – although it should be noted that Martin Wheatley’s use of this phrase only referred to the new power the regulator had to ban products, rather than its entire portfolio of activities.

*“The key difference between the future and now, and forgive me for being scary in my use of analogy, is we are being given the power to shoot first and ask questions later. Today’s approach is we find a problem and do lots of analysis, then we publish a set of draft rules and do a cost benefit analysis, we consult with the industry and you tell us we have got it wrong, and we publish another set of rules. A year later we get to the point where we think we got it right first time. We have got to reverse that process. The presumption is we will step in to make temporary banning orders, where products or certain features are removed, or removed from particular parts of the market, and then we will do the consultation and cost benefit analysis.” – Martin Wheatley<sup>49</sup>*

**New Assumptions.** The assumption of ‘rational economic actors’ at the heart of the FSA’s thinking was challenged. This entailed rethinking the idea that ‘everything and everyone behaves entirely predictably – or at least predictably in the classical economic sense: (1) where consumers are always rational actors, (2) where prices are competitive and respond to new information, (3) where people read and understood the terms and conditions.’ The FCA said that this was a false paradigm. ‘Looking back now, we can see this approach to regulation was flawed. It was too simplistic and inflexible. It left too many questions unanswered.’<sup>50</sup>

**New Functions and strategies.** To reflect its new operational objective to promote effective competition, the FCA created a new Competition division and recruited around 30 staff. A number of market studies were launched, including cash savings, retirement income products and general insurance add-ons. The FCA also developed a new communications and media strategy which was more overt, aimed at both consumers and regulated firms, had a more aggressive tone and was designed to establish an identity and establish with the industry what the FCA stood for.

**Areas for Change.** The FCA sought to change its culture to be more forward looking by:

1. Acting on market intelligence earlier from a wider range of market participants, including consumers, trade bodies and individual firms;
2. Being more willing to act on some hard evidence, rather than waiting for a comprehensive search for all possible evidence;
3. Being more willing to engage with the industry and trade bodies at an earlier stage.

There was also an acknowledgement that senior managers would maintain cultural control across the entire organisation. The 2014 FCA Board effectiveness review found that the FCA Board ‘sets a good example by attaching considerable importance to the FCA’s own culture’ but suggested that the formal mechanisms for assessing this should be improved.<sup>51</sup> The 2015 Board effectiveness review concluded that:

*“All directors are aware that a successful transformation from the FSA to the FCA is dependent on a tangible change of organisational culture. The previous regime is described as silo-orientated and defensive, and unlike the PRA, the FCA did not have the advantage of changing its location. There has been an effort to reconstruct the culture through teamwork (including the development of house views) and improved levels of openness. The current culture is described as professional, purposeful and increasingly collegiate. There is a mix of existing and newly appointed executives, described as engaged and with a good understanding of values, and staff survey results are improving.”<sup>52</sup>*

The FCA also articulated some cultural characteristics and personal qualities it sought to promote. These included:

- **Five cultural characteristics:** Backbone, Professional excellence, Curiosity, Already on the case, Strength as a team; and
- **Three personal strengths:** Judgement, Drive, Influence.

## FCA work on bank culture

At the same time as the FCA was seeking to understand and transform its own culture, it also sought to monitor the culture of the organisations which it regulates. In a 2013 speech, Clive Adamson, then Director of Supervision at the FCA said that 'Culture is like DNA. It shapes judgements, ethics and behaviours displayed at those key moments, big or small, that matter to the performance and reputation of firms and the service that it provides to customers and clients'.<sup>53</sup> In another speech, Martin Wheatley pointed out that 'You can't always react or respond to gross derelictions of moral duty with a tick list of technical submissions ... There has to be some sense of ethics and responsibility: of culpability when things go wrong and pride when things go right'.<sup>54</sup>

This emphasis on individual responsibility and culture led to a number of initiatives to track and measure culture within regulated institutions. The 2015/16 FCA Business Plan listed firm culture as one of its priority issues. It would conduct a thematic review on 'whether culture change programmes in retail and wholesale banks were driving the right behaviour, in particular focusing on remuneration, appraisal and promotion decisions of middle management, as well as how concerns are reported and acted on'.

On 31st December 2015 it became known that the FCA was scrapping its thematic review of bank culture and would engage with banks as part of the process of supervision. This meant there would be no public report published of the progress banks were making. Instead the results would be discussed with the banks in secret. The FCA also said that it did not want to duplicate the work of the Banking Standards Board (BSB). This was despite the fact that the BSB is a voluntary initiative, is not publishing a transparent assessment of progress and has no power to sanction any of its members. Some stakeholders thought that scrapping the bank culture review showed a complete insensitivity to the problems which still exist in the culture of banks. They thought the FCA was too optimistic about the progress that had been made and the potential to make further progress within a short space of time. Under the approach of the FCA and the BSB, individual banks won't be held accountable for progress and there will be no transparency or independent evaluation. There was concern that the FCA was trying to franchise out this vital work.

# Mechanisms for Cultural Change

## Competence development

**More Competent Staff.** The FCA sought to change the 'tone from the top' by strengthening recruitment of senior staff, testing their technical ability, but also examining their characteristics and behaviour. To further develop their existing staff, the FCA launched the FCA Academy. This offers executive education which involve technical academies, management training as well as an FCA diploma. Finally, the FCA reviews staff departures through tracking turnover, sickness and high performing leavers. It is examining how to manage risks with staff turnover and knowledge retention.

## Remuneration

**Pay and Bonuses.** Levels of remuneration are decided by the FCA executive committee. Staff can receive basic pay, membership of a defined contribution pension scheme and a performance-related bonus. This is determined by whether individuals achieve their objectives associated with the business plan as well as individual areas of responsibility. In 2015/16, 96.2% of staff received a bonus, with 80.9% receiving a bonus of more than a tenth of their salary. Directors can receive bonuses of up to 35% of basic salary – although in recent years bonuses have typically been between 15% and 20% of salary. We believe that bonuses for FCA staff, including directors, are paid in cash and are not subject to any form of deferral or clawback. There had also recently been across the board increases in holiday allowances.

## Hiring

**Reducing Staff Turnover.** The FCA stated that hiring was a major way it could build the right culture. An important part of this was hiring people who have more experience into established roles and ensuring new recruits have experience in the sector which they regulate. The FCA has also sought to cut down on the amount of turnover within the organisation – reducing turnover from 15% to 8.9% in the 2014/15, but this increased to 11.5% in 2015/16. Over one-third of employees have been with the organisation for two years or less.

## Performance management and promotion

**Better Performance Management.** The FCA has sought to connect its remuneration with performance. Remuneration for higher level executives is connected with achieving objectives set out in the business plan. We did not manage to discover how the FCA's performance management scheme operated for mid-level managers and frontline staff.

## Internal reporting of concerns

The FCA had a whistleblowing procedure with the ability to report concerns to line managers, internal audit or the Treasury.

## Measurement of success and employees

**Unclear Measures of Success.** The FCA used a range of measures to determine their success including

customer satisfaction, practitioner satisfaction, its staff survey, the number of breaches of the MoU with the PRA, the number of complaints closed from firms and consumers and employee turnover. It also reports data on enforcement action, including number of cases opened and closed, levels of fines and other penalties and the length of time taken to complete cases. Although the FCA claims to have an “outcomes-based” performance framework, it does not provide any clear detail about how it is measuring the vast majority of the outcomes outlined in the table below taken from its annual report.

## FCA: Measuring performance against the statutory objectives

Statutory objectives	Ensuring that financial services markets function well					
	Securing an appropriate degree of protection for consumers		Promoting effective competition in the interests of consumers		Protecting and enhancing the integrity of the UK financial system	
Outcomes	Consumers have access to fair products and services, which deliver what they promise	Consumers can be confident that firms treat them fairly and fix problems promptly	Competition contributes to improved consumer outcomes	Firms compete on clear costs and consumers have the information they need	Consumers can trust firms to be fit and proper and for financial markets to be clean	A respected regulatory system that lets good firms know where they stand
Outcomes indicators	Fair products and services	Building trust and engagement	Value for money products and services	Competitive markets	Clean regulated markets	Attractiveness of market
	Improved consumer experience	Effective remedies	Getting better service	Clear and useful information	Low financial crime	Respected, joined-up regulation

## Collaboration

**Within the FCA.** The FCA intended to ensure there was greater collaboration within the FCA to ensure that causes of problems are addressed before they can become full blown issues which firms need to take action to address.

**With Other Regulators.** There are also Memorandums of Understanding with other organisations such as those between the FCA and other regulators. The relationship with the PRA is particularly important in the area of policy making. The FCA do mention that the co-ordination between both regulators has been problematic at some points, which has 'led to some delays, and authorisations of firms and approvals of individuals, where there continue to be some systems issues that have caused delays to information-sharing.'<sup>55</sup>

## Leadership

**Board Membership.** The FCA Board is made up of a Chairman, the FCA CEO, three executive directors, the Bank of England's Deputy Governor for prudential regulation and four non-executive directors appointed by HM Treasury and two appointed jointly by HM Treasury and BIS. Following the financial crisis the Government made a concerted effort to appoint more individuals with a broader range of experience, including consumer experience to the FSA Board. This was partly in response to criticism that the FSA Board had been dominated by those with industry experience, including Sir James Crosby, who was CEO of HBOS whilst also being a member of the FSA Board. However, as the terms of the more consumer-focussed members of the FCA Board expired they have been replaced by those with more industry related experience. The Board meets around 16 times a year and publishes minutes of its meetings. Below the Board is the Executive Committee (ExCo), which is made up of the executive members of the Board – the ExCo does not publish minutes of its meetings. Every year a strategy day was held, last year it was at the O2, and the ExCo would all appear on stage together and take questions from the audience of FCA staff.

## Internal / External Challenge

**Consultation with consumers and firms.** The FCA has duty to consult both consumers and practitioners when proposing policy and guidance. It also has a formal duty to consult the PRA. The FCA was required to consult the four panels established by legislation – the Practitioner Panel, Smaller Business Practitioner Panel, Financial Services Consumer Panel and a new FCA Markets Practitioner Panel. A new Consumer Network was established, including 10 consumer groups – to try and ensure that the FCA engaged with a wider range of consumer groups. The aim was to identify the early indicators that may alert the FCA to issues or trends that could harm consumers. For example, collaboration with Citizens Advice highlighted the consumer harm that was being created by credit brokers.

**Occasional Papers.** The FCA published a series of Occasional Papers on priority subjects such as the use of behavioural economics, trials of different approaches for redress and information provision and consumer vulnerability. The Paper on Consumer Vulnerability developed a definition of vulnerability and was designed to stimulate debate and aid firms in developing strategies to deal with vulnerable consumers, such as those suffering from illness, disability or bereavement. It is not clear how the conclusions from these occasional papers are taken into account in FCA policy development.

## FCA Staff Responses

**Staff Survey Results.** The FCA conducts an annual staff survey. The FCA refused to publish the results of this survey until it was compelled to by a Freedom of Information request, perhaps not an indicator of a wholehearted commitment to openness. The survey covers issues including engagement, wellbeing, leadership, line management, development of the FCA, career & talent management, working at the FCA

and performance support. In the majority of the categories, favourable responses had deteriorated since 2014, with the largest declines in the areas of leadership and performance support. The results are below the comparable benchmarks for UK financial services companies in all areas except engagement, wellbeing and line management. However, the FCA's results are above the UK public sector norms.

## FCA 2015 Staff survey results

Category	Total Favourable Score FCA 2015	Compared with		
		FCA 2014	FCA 2013	UK financial Companies
Development of the FCA	73	-3	2	-6
Leadership	50	-7	-5	-7
Engagement	84	-2	2	5
Wellbeing	80	-1	2	14
Career & Talent Management	44	-3	3	-6
Line Management	80	0	1	1
Working at FCA	63	-3	1	-7
Performance Support	62	-9	-9	-7

In addition to the FCA's own survey, we spoke with a number of current and former FCA employees about the culture of the organisation. They identified a range of drivers and inhibitors of cultural change at the regulator.

## Drivers of Change

**Leadership.** When Martin Wheatley took over at the FCA, he introduced a more muscular approach to enforcement. One ex-staff member told us that 'Wheatley was a galvanising force – people felt backed up



and like they had a mission'. Another said 'Bold statements that the regulator would be more proactive and aggressive (changing tone from the top) were well received within the regulator and were helpful to drive staff. 30% extra resource was put into enforcement –to back up the tougher talk'. Some dissented with one person telling us that 'Management lacked gravitas, lacked visibility. They sat in an ivory tower. Communication from management was lacking'.

**Significant Cultural Change.** One employee told us that there was a 'Lot of emphasis at the time from top management that this entailed cultural change. They established new cultural characteristics. They emphasised a more proactive regulator, who doesn't retrospectively respond but acts sooner.'

Many staff thought the cultural change was well communicated. One said there was 'Lots of good internal comms and learning opportunities: Culture change was achieved through regular communication from senior management, know-how sharing'. They also described how top management 'really communicated what (the cultural values) means in practice'. These values used to be their screensaver. We were told 'there were internal values champions who initially let people know about characteristics and what they meant. This was Stage 1 –raising awareness. Since 9 months ago, it's Stage 2 –now they are aware but need to continue to embed it'. Another ex-employee of the regulator told us the 'change processes were very good. There was much better and more frequent feedback provided by senior executives to frontline staff. Senior staff – in particular Martin Wheatley – actually walked the floor and held informal and formal feedback sessions. Staff were encouraged to read speeches from senior executives. There were large divisional meetings to get everyone engaged'.

This was not just 'tone from the top', but appeared to be translated into a larger cultural change initiative. One staff member we spoke with told us that there had 'been a big culture change effort, with initiatives starting when the FCA was created, where a new set of values and corresponding behaviours were

announced. '[Managers] had to roll it out to the entire population [of staff] and take people with them, embody [The values]. And we have staff surveys, which ask our staff if they know what the values are and what they mean, I do not have the numbers, but I know that more and more people know what [the values] mean for their jobs on a day to day basis'.

Although staff saw a clear process, there was also a significant amount of ambiguity. One employee we spoke with didn't really know what this process of 'embedding' entailed. They pointed out that there were 'values champions', but they were changed every year. The employee also pointed out that staff 'Used to make fun of [the new FCA cultural characteristic of] 'Backbone' because it wasn't obvious what it meant'. They also noticed that the cultural characteristics were 'not part of the annual appraisal, but something in bear in mind and something that comes up in conversations'.

We were unable to find any written documentation which outlined the full extent of the FCA's cultural change initiatives.

**Friendly.** Staff said the FCA had a relatively friendly and supportive culture. One ex-employee we spoke with told us that 'when I moved into the regulator I was pleasantly surprised about the friendliness and openness of people, the organisation was set up relatively straight forward, everyone had their name on top of their screen, so it was easy to identify and find the people around ...so my initial impression was, this feels relatively commercial, and not as archaic as I would expect. My expectation was to get to an archaic, paper-ridden place. Instead I found a positively surprising environment'.

**Sense of purpose for individual employees.** Many of the regulatory officials we spoke with told us that they had a clear sense of purpose. One person told us 'my colleagues are very proud of what they are doing. Me too.' A number of senior regulatory officials we spoke with who now work for banks or advisors continued to identify with their previous roles at the FSA/FCA. A common metaphor used to describe themselves was like 'Blackpool rock – if you cut me in half you will see FCA written right through me'. Many of the employees reported feeling challenged in their jobs. They said job satisfaction is generally very high. According to the employee survey results, everyone working there is really committed to the organisation. Often this was related to the kind of job they were doing – they felt that it was 'something worthwhile'.

**High Calibre staff.** Many of staff and ex-staff we spoke with told us that employees at the FCA were generally very high calibre. One person told us in their team all staff came 'from strong academic backgrounds, good quality intellectual people' and this was 'consistent across most of the people I met' working in the FCA. Another told us that 'the calibre of people was unbelievable'. This employee thought that they would 'shoot to the top there after extensive industry experience, but the talent pool was unbelievable. I didn't expect this outside the private sector. They had top lawyers from the Magic Circle firms. They wanted better work/life balance but still with the challenge. They have better hours here'. In journalist Joris Luyendijk's investigation of the culture of the London financial industries, he spoke with a senior regulator who said that 'the perception is that the regulator is sort of the B-team, those who didn't make it in, or into, the banks. It really doesn't seem like that at all, on the ground. There is more room to be eccentric here, certainly, as the culture is less conformist. But B-team? Just ask recruiters – they give us job offers at banks all the time'.

**Learning opportunities.** The final factor which the staff and ex-staff we spoke to thought was positive was the availability of learning opportunities. We were told that the 'Training sessions are remarkably good. Under

manager level, you don't go away for residential training but experts and academics regularly give a talk on topical issues, such as behavioural economics or from Bank of England talking about where the economy is going in the next 3 months. There are weekly departmental and team meetings, where the department head shares publications ... everyone is encouraged to share any interesting aspect they encounter during their work'. They also told us about 'It's like going to University, constantly getting the latest research and development within the financial industry. The FCA Academy provides all full time members of staff an opportunity to enrol in an MA degree in financial regulation.'

## Barriers to cultural change

**Overload and Pressure.** The first factor which employees thought was a significant barrier to positive cultural change was organisational overload. One ex-FCA employee talked about the 'feeling of being embattled by external pressures like the Treasury, banks, and politicians. This meant the organisation was a bit reactive. It was difficult to clear space to be more proactive'.

**The banks were clearly one important source of pressure. Another was the Treasury and politicians.**

We were frequently told that the FCA was at the bottom of the pecking order with the Treasury, the Bank of England and the PRA above it. One ex-regulator told us that 'Treasury and politicians directly influenced the regulator. Treasury could change legislation but also held meetings with the regulator'. This external influence can be harmful when there are constantly shifting messages and demands. 'To support the process of cultural change the regulators need stability. The political messages have got to be consistent'. One person pointed out there was a high degree of cautiousness because 'People working at the FCA now could find themselves on the wrong end of a government soundbite'.

Most of the people we spoke with recognised that there are many regulatory agencies within the financial markets, and each of these agencies has been extending their regulatory remit in recent years. This does not only leave banks dealing with additional regulations, it also means other regulators spend much of their time processing and harmonising regulations produced by other regulators. One person we spoke with told us that 'much regulation came from Europe which left little space for domestic regulators'.

The overload which comes from an externally imposed agenda which is constantly shifting has an impact on individual employees in the FCA. One person we spoke with in the FCA said 'it is not enough to have these (values) set in stone, we need to ask ourselves does the environment allow me to put the values into practice? For example, If I am overloaded with 60 hours work, how can I be curious? ... the environment needs to allow the values to flourish; it is not enough to have the values and ask the staff if they understand them. And I am not sure all the managers have the same awareness at the FCA'.

**Little external recognition.** Alongside a large amount of external pressure, regulators felt that they received little external recognition – particularly for doing things right. One employee of the FCA told us 'a regulatory body is a difficult place to be ... because if you do your job well no one knows it, but if you are held to account for what goes wrong, then we are perceived as really bad'. This employee added that 'our biggest successes are kept secret. A lot of our success is unseen and unspoken, and it should stay like that! When banks got into trouble we made sure by working with them that they didn't fail. We worked with the industry making sure that people's mortgages were fulfilled, same for many other events when we were

instrumental in protecting consumer's interests. Those successes were not celebrated because that is the way it is. We enact a role of custodians of the system'.

**External pressures could lead to mistakes.** There was some concern this external pressure could lead to the FCA making similar mistakes to those the FSA made during the financial crisis all over again. One person we spoke with mentioned 'a reticence because of [the] 'Martin Wheatley sacking [for being too tough on the industry] and the strong pro-business rhetoric'. The political stance will inhibit the appetite to act aggressively. We were 'entering new phase of the standard cycle of, crash/scandal, regulator becoming more aggressive and then swinging back to light-touch. Watering down of reverse burden of proof would make it harder for the regulator to take action against individuals'. The government was undermining the confidence of regulator which will have a knock on impact on efficiency. The regulator was supposed to be independent but there was a 'clear danger of going against the Government...the regulator doesn't have independence - it would be emasculated and afraid to be aggressive. The individual appointed (as the new CEO) would [need to] set [a] new tone from the top'.

The challenge of external pressures were also identified by the FCA Board effectiveness review. It said that recent interventions and criticism were affecting morale and leading to a number of problems:

*Directors acknowledge that recent interventions (Davis, TSC, HM Treasury), and levels of public scrutiny and criticism have impacted negatively on culture and morale, influencing executive cautiousness, levels of defensiveness, and the willingness to escalate issues and learn from mistakes, as well as, potentially, attracting and retaining talent. During September's [2015] [Audit Committee meeting], one director noted that the biggest risk for the Board is the current level of organisational change.<sup>56</sup>*

**Turnover and Career progression.** A further barrier to cultural change mentioned by FCA employees was turn-over of personnel. An ex-regulator we spoke with told us that 'there had always been a retention problem at the FCA. The regulator pays a reasonable amount of money. But people left – and continue to leave - because of repeated change or because change had been reversed'. Another added that following the financial crisis, the FCA became a 'parking spot' for many people who had previously been employed in banks. One regulatory official describes the situation as follows: 'The financial crisis did a number of interesting things the FCA needed to recruit a number of external people, simultaneously banks were not hiring anymore. So a lot of people from banking went into the FCA as a parking spot, waiting for the recruitment in banks to pick up again, and then leave, and put a couple of years experience in one's CV, and then trying to get out again'.

Closely linked with issues of turnover were concerns about a lack of career progression. This was succinctly explained by an ex-employee who said there is 'still problem of progression –there was zero scope for promotion/career progression. People knew that they were never going to get promoted. You had to leave and many did'. Another person told us that 'if you come from a bank and you want to have an idea of career progression and that your voice is heard, it is more suffocating, you always need to wait your turn to get a decision made. It's down to processes; if you are used to getting decisions made quickly this can become frustrating ... This is also happening now, people that have joined the FCA from the banking industry are desperate to get out of the FCA ... They just come in for a couple of years, put it down in their CV and move back to the firms'. Promotion was also based on reputation and image of an employee rather than independent assessments of performance. Another person added that 'the negative (of the FCA) is that

it's a very flat structure. It is very difficult to get promoted. Progression is much harder than at any other company'. This employee noted that the FCA would generally 'Matched the salary (they had at the) bank, but the salary doesn't tend to rise'. This employee told us how they were frequently called by recruitment consultant but that they 'don't want to do a less meaningful job for a bank for 20K more'.

**Bureaucracy and silos.** A further barrier to cultural change is extensive bureaucracy and organisational silos within the FCA. This slowed down change processes as well as displacing work. One ex-employee told us that at the FCA 'it takes a week to do the work, and months to get it through the committees and structure'. Part of this was due to a bureaucratic heritage within the organisation. One employee mentioned that 'people that had been there for a long time were very structured and bureaucratic, slow, procedural and methodical in making decision'. This meant it would take a 'long time for decision making but be relatively transparent. The people that would come from different organisations, who were all a little frustrated that some decisions need to be made much quicker, but these people ... would understand why decisions were made so slowly, and also why often decisions were not made at all.' It was also mentioned that 'if something is in writing at least a 100 people needs to review it'.

One side effect of these bureaucratic processes was that they created silos within the organisation and barriers to communication between different departments. One person told us that 'although it was a friendly environment there was not much cross-divisional fertilisation, there was a culture of silos. Whether it was personality or structure, I was surprised I could never get to communicate across departments as I would have wanted, It might have come down to politics, to turf wars amongst management people, there was an element of land grabbing and ambitions'.

One of the central tensions continued to be between the supervision and enforcement departments. A regulatory official in a bank described how this relationship was 'a constant negotiating process. Supervisors are really busy, deal with all the difficult jobs, they need to anticipate what will blow up next so they have to be always on the ball. They are always busy and arguably overworked.. They are concerned that enforcement may compromise the relationships they built with the banks. It is very political'.

## Summary – FCA staff views on the organisation's culture

There are some clear positives at the FCA including a sense of purpose, a friendly environment, high quality staff and many learning opportunities. There are also negatives include staff turnover, overload and external pressure and bureaucracy. There seemed to be an overarching concern that Martin Wheatley had galvanised staff, but that there was a danger of back-sliding.

The mixed culture at the FCA was very well captured by one employee who described it as the following: The positives: as a working environment is open and transparent, and the work life balance is better. There is an amount of work to do and you do it...it was interesting work, you felt you are making a difference, the remuneration was ok, but that some people coming from banks were paid more. Probably what was not so good was that there was poor cross-fertilisation, it was bureaucratic, but ultimately you understand why because everything had to be documented because of freedom of information, you need to have an audit



trail. The area in which they could have done better about career questions; also decision-making changed, I felt there was more responsibility given at a lower level and that seems now to have disappeared, the decision making has gone up again particularly on the firm supervision side'.

## Common themes across the Bank, PRA and FCA

There were a number of common themes in both the organisations which have been identified as needing improvement.

### Hiring and Turnover

**High Staff Turnover.** Both regulators had developed long term strategies to attract talent. However, it was not certain whether these strategies were actually working. 26% of resignations from the PRA in 2013 were identified as 'high performers'. In October 2013, 34% of FCA staff had only two years or less of experience with the regulator. This loss or lack of experience could lead to a troubling situation where the industry began to see the regulator as inexperienced, thereby undermining their capacity to regulate.

### Measurement

**Unclear Measurement.** There needed to be further evaluation of the costs and benefits of the activities of the regulators. The FCA only assessed the costs and benefits of what it planned to do and did not evaluate different options. Both regulators planned to develop a method for directing regulatory resource – but they had not done so as yet.

Each of the regulators needed to go further to refine their means of measuring the impact of their activities. The NAO report states that 'each regulator has established a performance measurement framework, set out operational aims and what success looks like, and developed metrics for measuring performance. At present the metrics do not bring together information on whether their intended outcomes are being met and the contribution that each regulator's performance makes in achieving those outcomes. The PRA Board has reviewed and revised its management information in taking an early view on its strategic focus, but the FCA has not yet planned a similar exercise.'<sup>57</sup> Although there is some intention to measure performance, there is also little in the way of a systematic frameworks within which to undertake this activity.

## Collaboration

**Poor Data Collection.** There has been a significant change in the way that the regulators supervise firms. One of the most significant aspects of this change has been a move to forward looking regulation and also a greater emphasis on issues such as conduct and risk rather than just compliance with legal standards. Despite improvements, there are some potential shortcomings. It was too early to evaluate the effectiveness of this new forward looking approach to regulation. There are also some important shortcomings with data collection systems. In particular, the regulators don't have a strategic approach to understanding the data which they hold and how it might be used.

## Transparency

**Lack of Transparency.** There are also issues around transparency. The FCA and the PRA were somewhat opaque and it was unclear how they operated internally. Also, due to the restrictions imposed on regulators by Parliament, the auditor was unable to gain full access to information from the regulator. In a recent study into the action taken by the FCA to prevent mis-selling, the NAO said that the restrictions limit its "ability to reach a judgement on the FCA's value for money, as we could not carry out a full assessment of the effectiveness of the FCA's actions. For instance, we have only limited evidence on how the FCA's actions have changed firm behaviour, and how effective its redress schemes have been in providing compensation to consumers."<sup>58</sup> As we will see in the next chapter, this was an issues which was mentioned by many of the stakeholders with whom we spoke.

## Conclusions

Both the PRA and the FCA were founded on the assumption that something needed to change not just in the rules, governance arrangements and the structure, but also the culture of the regulators. In this chapter we have seen there was commitment from senior leaders in each organisation that they would introduce a new approach to regulation. The PRA would move towards a more judgement based approach. The FCA challenged some of its core ideas about the market it regulated and tried to adopt a more forward looking and proactive stance on regulation.

To deliver these changes, we saw each organisation adopted varying strategies. The PRA is part of the BoE's more integrated One Bank strategy which has sought to clearly articulate some core goals, cultural

values and other typical aspects of culture. It has launched a change programme similar to what you might find in many financial sector organisations involving shifts in remuneration structures, measurement, hiring, talent development and collaboration. There has been some push back from longer serving staff members for instance. Overall the cultural change initiative seems to be proceeding relatively smoothly. From our discussions with various stakeholders, it appears that the PRA was becoming increasingly integrated within the BoE.

This contrasts with the FCA which has adopted a more fragmented approach. When the new regulator was established, its senior leaders made a number of speeches emphasising the need to adopt a new culture. There were attempts within the regulator to do things like articulate values, make changes to hiring systems, measurement and performance management, remuneration, talent development and collaboration. However there was a lack of an overarching logic to much of this change. There was no equivalent to the One Bank strategy. In addition, many of the initiatives appears to involve assurances that senior leaders were developing the culture. There was less in the way of concrete changes which had been delivered. The FCA continued to be given new responsibilities including the regulation of the Consumer Credit sector and the establishment of a Payment Services Regulator. Further turmoil was also created by the inquiry by Simon Davis of Clifford Chance into its briefing of the press around the launch of the supervisory work into the fair treatment of long standing customers in the life insurance sector. It came under greater and more negative scrutiny from politicians, the media and regulated firms. This created further structural change within the regulator,<sup>59</sup> the perception that politicians were influencing its work and the departure of the CEO, followed by the appointment of a temporary replacement. As a result exactly how the FCA was transforming its culture remains unclear and difficult to understand. The FCA did not have a comprehensive programme of cultural change in place and therefore was blown off course and risked not achieving its objectives.





## Stakeholder Responses to Cultural Change in the UK's financial regulators

In the previous chapter we saw that the financial regulators have put in place significant cultural change initiatives following the financial crisis. Staff working in these regulators have judged these changes as being a mixed success: Some aspects have been changed such as tone from the top, remuneration and opportunities for development. However there remain a number of important issues which continue to hamper the regulators such as overload, bureaucracy, staff turnover and a lack of clarity about what they are trying to achieve. In this chapter we will look at stakeholder's perceptions and evaluations of cultural change within the main financial regulators.

# Bank of England

**High Status.** The Bank of England was seen as a high status place to work and was widely respected among all the stakeholders we spoke to. It was seen as having high quality people, producing excellent quality outcomes and being relatively even handed in the way it operated. The various reports, speeches and other interactions with the Bank were generally appreciated by stakeholders.

**Discrete Intervention.** Most stakeholders point out that there had been changes in the way in which the BoE operates in recent years. One commentator on the sector told us that 'We have witnessed a decline of nudge and wink regulation'. A senior regulator official in a large bank told us that in the past officials at the BoE had a close relationship with the institutions which they regulated. Officials in the Bank had a close knowledge of how the banks they regulated actually operated. If there was a problem, banks would often be notified discretely. We were told that, in the past, 'They called you into a carpeted room to give you a carpeting'. This tradition of intimate knowledge of regulated institutions as well as discrete interventions was seen as continuing to inform the culture of the BoE today.

**Lack of Transparency.** Although most people we spoke to were positive about the BoE, some pointed out that it lacked a degree of transparency. One person pointed out that the architecture of Bank itself said something about the culture of the institution. The solid walls around the bank symbolised how it was cut off from the rest of the world. They quipped 'the walls around the bank were once there to keep people out and ensure the gold inside was safe. Now they are there to keep the Bank employees in'.

**Compensation.** We were told that relatively low levels of pay – particularly at the junior level – might make it difficult to attract the best and the brightest. This has been compounded by rising property prices in London which meant many new recruits struggled to find suitable accommodation. Changes to pensions meant that lower rewards in the short term are not balanced out by generous rewards in the long term. There were some concerns about homogeneity of background and thinking within the institution. Many of the staff came from an elite background. Someone we spoke with described it as the 'Eton and Balliol' of regulators. One person told us that 'If you didn't get out at 30, you can't get out' and 'once you get to the top of the organisation, there is a homogenous culture of long stayers'. This could have been due to the generous final salary pension scheme, which is now no longer available. It could also reflect a culture which valued long service: we were told that anyone who left the Bank before retirement was known as a 'quitter'. Finally, there was concern among a few stakeholders we spoke to that the focus on economics driven policy making in the Bank has meant that 'people at top had been governed by academic theory. This was illustrated by Northern rock and [the focus on] moral hazard'.

**Lack of Challenge.** There were also some concerns about the extent of challenge to the Bank's strategy provided by the Court. Those who knew the history of the Bank described the Court's role in the past as "decorative", although they were aware that there had been some changes made recently. The concerns about the potential lack of challenge were exacerbated by recent changes which included reducing the number of non-executives from 9 to 7 and abolishing the Oversight Committee composed of the non-executives. It was also noted that although the NAO was now able to conduct Value for Money (VFM) studies of the Bank, it required the permission of the Court and was restricted from examining the 'the merits of the general policy of the Bank in pursuing the Bank's objectives'. This was seen as fettering the discretion of the NAO. There was also a 'superior' attitude amongst the Bank which was not welcoming of external challenge – for some meeting the Bank was like meeting an 'arrogant version of the Queen'.

**Group Think.** The concern about the lack of challenge was heightened as the Bank was also seen as institution vulnerable to 'group think' as one person said to us 'the Bank was very efficient at getting stuff done but free thinking was not encouraged'. The Bank had failed to warn about the build-up of excessive risk in the financial system prior to the crisis and was fully bought into the mistaken paradigm that the UK banking system was more resilient than ever. It was also noted that the legislation governing the role of the Financial Policy Committee required it to reach consensus wherever possible – which could discourage robust challenge or those with maverick ideas. This could delay action which needed to be taken to tackle financial stability risks.

**Engagement with the public.** Prior to the Open Forum, engagement with the public and consumer groups was not seen as being a priority within either the Bank or the PRA. Then, in November 2015 the Bank hosted its first Open Forum – which was the first time in its 300 year history it had brought together all of the stakeholders to discuss the progress toward fixing the financial sector. The Open Forum was 'an opportunity to hear a different set of views from a different set of voices: from the customers and users of finance, as well as the producers and investors'. The Open Forum was seen as an important innovation and stakeholders thought that it was vital that the Bank built on its success by ensuring that engagement with consumer groups and the public was an ongoing process and not just a one-off event or PR exercise.

## Prudential Regulator Authority (PRA)

**A High Quality Institution.** The PRA was generally seen by stakeholders as a high quality institution. They told us that since moving into the Bank, the PRA had adopted a more judgement based approach to regulation. This meant it 'looks at the overall picture, not just the details'. The culture of the PRA benefited from a low level of staff turnover (although this was increasing) and that staff had a clear view about their role – which enabled them to be clear to firms about what they expected. Bank of England/PRA staff also had a clearer view of the organisation's values and beliefs, how their performance was assessed and their ability to progress their career at the Bank/PRA. Most stakeholder believed that staff at the Bank/PRA tended to see they could have a long career at the regulator and would receive some prestige or non-financial reward.

**PRA better with the Bank.** Most people we spoke with pointed out that it had improved significantly since the PRA was created and made a subsidiary of the Bank of England. One person we spoke with told us that 'the BoE culture, after the crisis, permeated the PRA, lots of senior people moved to the PRA very quickly'. In addition to a shift within the culture people told us that the PRA had benefited from getting many of the high quality staff from the old FSA. A senior regulator at a large bank told us that 'the PRA worked because it had the bench strength, it had the mandate, it was focused and thoughtful about its approach and knew about gaps in its capabilities'. Another person we spoke to told us that the best people tried as hard as they could to join the PRA following the restructuring of the FSA.

**Clarity of Purpose.** There was clarity amongst stakeholders about the PRA's central purpose and what it was trying to achieve – a safer and more stable financial system. There was also clarity about what the PRA expected from the banks – partly due to the fact that the engagement was over factors like capital levels and 'the PRA spoke in numbers', making clear what they expected to be achieved and by when. There tended to be 'no surprises' from PRA supervisors.

**Lack of Empowerment for supervisors.** The only reservation expressed was that supervisors were not sufficiently empowered to exercise judgement and sometimes did not feel able to answer questions. The PRA/Bank was still a hierarchical organisation and sometimes to make a decision, staff had to pass it all the way 'up the line' to senior management. This was due to a 'culture of fear' of making the wrong decisions. There was a 'one-tailed' distribution for supervisors – they could never make mistakes or take risks as if they did it would have a severe impact on their career. It was noted that 'you can't run a business with a group of risk managers who will never make mistakes – they will constrain it.' Regulators needed to have processes in place to ensure that they learnt from any mistakes.

**Disconnect between Misconduct and Prudential Issues.** Although the PRA did not have any responsibility for conduct regulation some stakeholders thought the PRA needed to do more to grasp the interconnectedness between bank misconduct and prudential issues. The losses to banks from retail mis-selling and misconduct had been significant – over £54 billion in the past 15 years.<sup>60</sup> Whilst the PRA now included misconduct issues in its stress tests, it had failed to discuss these issues with consumer groups and as a result some consumer stakeholders believed that it had understated the possibility of misconduct losses in the major banks in a stress scenario. The PRA also needed to understand that misconduct issues around products such as Buy-To-Let mortgages could lead to greater losses for banks in the future.

## Costly regulation

Regulation has become more costly, both to comply with and to oversee. The total administrative costs of operating the FCA, PRA, FOS, FSCS and Money Advice Service are now almost £1.2 billion a year – a six-fold increase from the £200 million the FSA, FOS and FSCS cost in 2000. Recent increases in administrative cost have been driven by changed approaches, particularly additional front-line staff, and additional costs to replace information technology (IT); and to the costs of running two regulators instead of one. The higher costs of the FOS are mainly the result of a long-term failure by major high-street banks to deal with PPI complaints effectively or fairly.

In addition to the administrative costs of the regulators there is also evidence that the cost of complying with the regulation had increased. HSBC recently announced that it was hiring 3,000 more compliance officers. 88% of large firms and 44% of smaller firms surveyed by the FCA practitioner panel in 2015 reported devoting more time and money to regulation over the past 12 months.<sup>61</sup> The FCA and PRA are required to consult before introducing new regulation and conduct a cost-benefit analysis which includes an estimate of the costs and benefits of the new regulation where possible. But these were often seen as an after-thought rather than as a driver of policy. Indeed the FCA has stated that it is not required to assess the costs and benefits of a number of possible options, but only the option it has chosen to implement.<sup>62</sup>

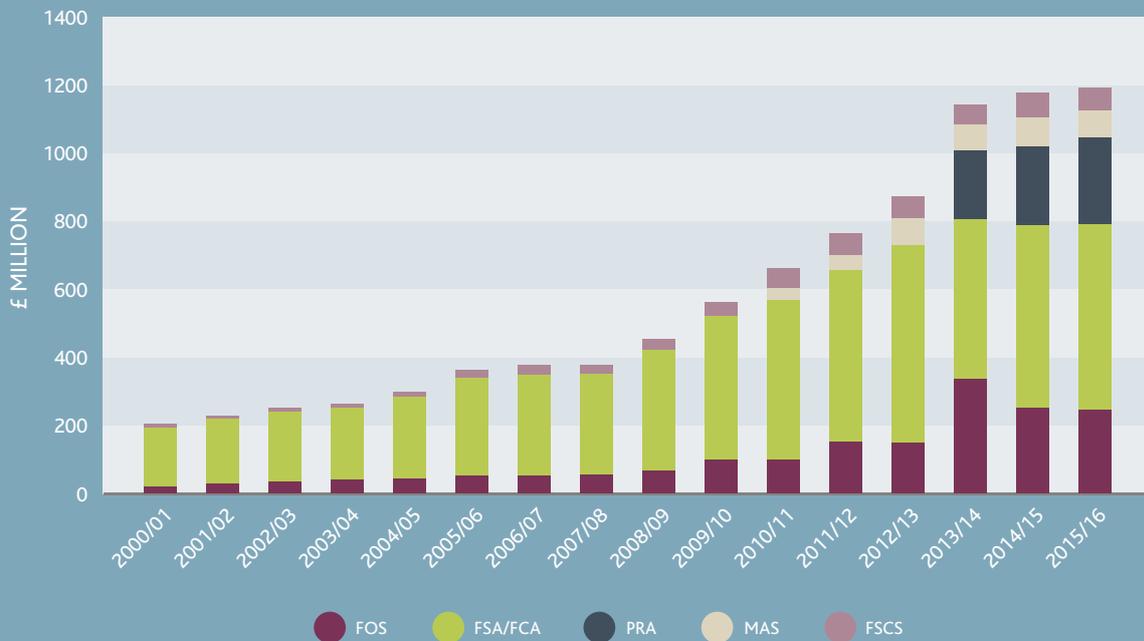
The benefits of financial regulation are also poorly estimated. The financial crisis highlighted the large economic and social costs associated with inadequate financial regulation. New City Agenda has estimated that the top 10 misconduct scandals in retail banking have cost banks and their shareholders over £54 billion in redress and financial penalties since 2000.<sup>63</sup> Stronger and more

proactive regulation can save both consumers and the industry money in the longer-run. For example if the FCA had decided to intervene quickly and efficiently and ban single-premium PPI and heavily restrict the sale of other forms of PPI in 2005 then banks would have paid out £15-20 billion less in redress and associated administrative costs.

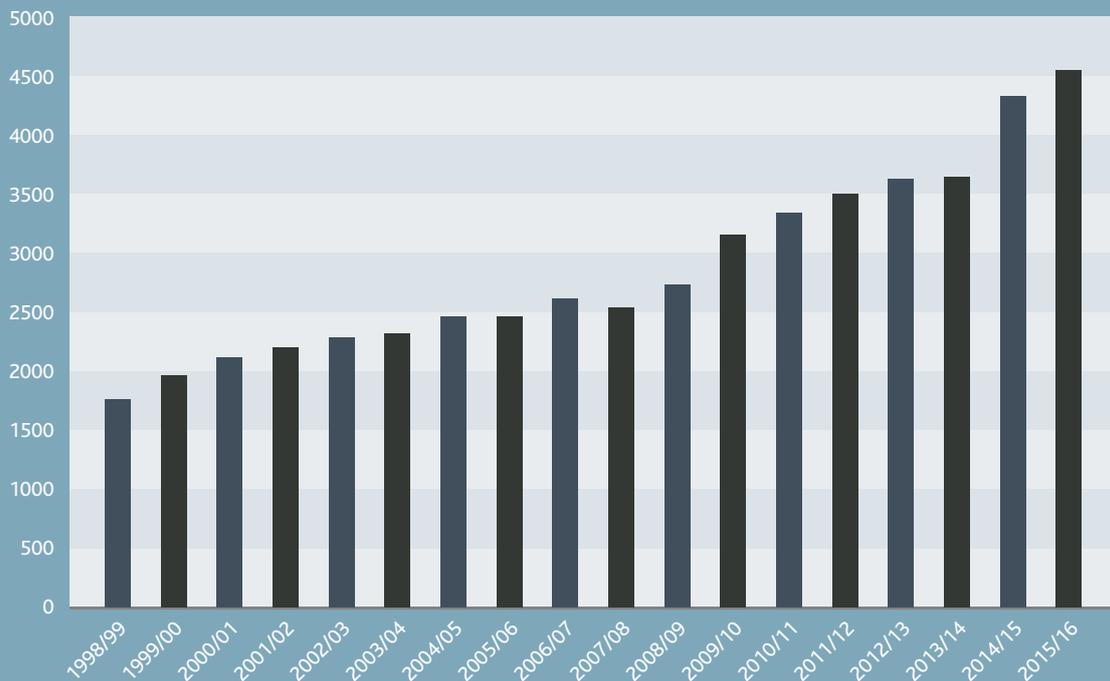
Regulators and other stakeholders seemed to be placing a lot of faith in the introduction of the Senior Managers Regime to improve compliance and reduce overall cost. It was thought that identifying individuals and holding them to account could enable a reduction in administrative box-ticking and, it was hoped, in the longer-term the need to take costly enforcement action. There was also the hope that the use of technology could help firms better manage regulatory requirement and reduce compliance costs – this was known as 'RegTech'. The FCA had issued a call for evidence concerning how RegTech could improve efficiency and transparency and whether there are any factors which are restricting the development of RegTech.

As part of the Enterprise Act 2016 the Government has set a £10 billion target to cut the cost of regulation during this Parliament and expects regulators, including the FCA, to play a part in this initiative. Regulators will need to undertake and publish assessments of the economic impact to business of any change to their regulatory policies and practices. These assessments must have been verified by the Government's Regulatory Policy Committee – an independent body which will scrutinise the evidence for the regulatory proposals. The Bank of England and the PRA are outside the scope of the Enterprise Act.

## Administrative costs of UK financial services regulatory bodies



## Staff numbers at FSA and FCA/PRA



## Financial Conduct Authority

**Mixed Attitudes.** Whilst stakeholders' attitudes towards the culture at the BoE and the PRA were generally positive, attitudes to the FCA's culture were much more mixed. They ranged from mildly positive to very negative. Some regulatory officials and consumer groups took the more positive tones and acknowledged that the FCA had improved in recent years and it was doing a good job given it faced so much pressure from many powerful stakeholders. The CEO of a smaller institution we spoke with exemplified the more negative attitude. He told us that 'If I ran an organisation with culture like the FCA, the FCA would come in and try and shut it down'.

**Culture has Changed.** There was an acknowledgement that following the financial crisis the culture had changed within the organisation, with the disappearance of light touch regulation and a more robust and consumer-focussed approach. Many of the banks thought this went too far under the leadership of Martin Wheatley, and they hoped for a co-operative approach in the future. However, stakeholders also acknowledged that there were a number of underlying issues which needed to be addressed. These included questionable quality of some staff, the continued prevalence of tick-box regulation, increasing complexity, risk-aversion, the continued existence of silos, and difficulties in addressing problems associated with big data. Some of the people who worked closely with the regulator acknowledged that the culture had improved following the formation of the FCA. This mainly was due to the FCA having more resources and being more robust in its responses to banks, which meant it had enabled the organisation to attract and

retain high quality people and give employees there a sense of power and purpose. One person we spoke with told us that “the work is more interesting than it used to be. They still prove successful in attracting people there ...the salaries have gone up –they do not feel anymore as the poor relative. Because they have more teeth and power the regulator feels to have more ability. If you work there to improve the way the industry works...now [the FCA] are more in the position to make changes, to have an impact on how things work. They were muted in the past, and the balance has shifted, so there is more potential in getting satisfaction on the job right now’. Another person we spoke with acknowledge that there has been ‘significant improvements especially in terms of challenging the received wisdom’ which has led to ‘improved welfare for consumers’.

**Progress in New Areas.** In addition to some improvement in the culture, stakeholders which we spoke with acknowledged that the FCA had made progress in addressing new sectors. In particular attempts to support FinTech innovation through ‘project innovate’. One person we spoke with acknowledged there had been ‘progress in the P2P sector: It was not business as usual for regulators. Regulators were being driven to engage with the P2P sector in a much more informal way than with other sectors. The FCA had a genuine recognition that they had to learn about the P2P sector. FCA staff learned quickly, but were also asking lots of questions to P2P lenders. The FCA was very open, even though our organisation does not have a dedicated supervisor.’

**Effective action to tackle problems in the payday lending sector.** In the Payday lending sector the programme of work instituted by the FCA included stronger rules on affordability, restrictions on collection practices and a price cap were seen as successful in tackling problems in the market. Stakeholders welcomed the analytical approach to setting the price cap and the work undertaken to understand the business models of the payday lenders. In this sector the FCA had enjoyed strong political and consumer group support for the action it had taken. Citizens Advice has reported that problems reported to them about payday lending had halved since the introduction of the new requirements. The FCA had also required a number of payday lenders, including Wonga and Dollar Financial to pay redress to consumers for their past misconduct.

**Increased willingness to address problems.** Some people we spoke with notes that the FCA has become more willing to recognise and address problems. One told us that ‘FSA executives and board members were unwilling to take career limiting decisions by upsetting the industry. This led to a culture within the FSA of trying not to upset the industry unless it was really important....If you found a problem, the FSA board would be unhappy that a problem had been found. The FCA Board would be happy that a problem had been found’. The FCA had been more proactive in addressing issues surrounding sales incentives schemes for frontline bank staff, required banks to change the structure of schemes and had taken enforcement action.

**More proactive engagement with consumer groups.** Consumer groups noted that the engagement they had with the regulator had improved as part of the transition to the FCA. They had a single point of contact within the FCA and staff within the regulator were more likely to seek out the views of consumer groups when formulating policy. Beyond consumer groups, with the exception of a few events surrounding its formation, the FCA made less of an effort to reach out to members of the public or to solicit their views. Responses to consultations continued to overwhelmingly come from firms and industry representatives.

**Light touch regulation disappears – shoot first, ask questions later.** Many interviewees mentioned the quote from Martin Wheatley: ‘shoot first, ask questions later’. Although they knew this quote was taken out

of context, they thought it captured the more robust or 'aggressive' stance of the regulator. One official in a bank we spoke with told us that following the financial crisis 'the sense of common purpose' seemed to disappear, because the regulator started to perceive themselves as being too close to firms. Light touch regulation disappeared'. Another person we spoke with told us that 'Wheatley was given an aggressive mandate, shoot first ask later, and his departure marks a political tone change. Maybe the FCA overshot their aggressive stance, but as conduct regulator it was right that they became more aggressive'. An asset manager told us that 'before 2008 if a firm would breach a regulation they would receive a slap on the wrist, but now they pay thousands if not millions of pounds. They (the FCA) want to be taken seriously, and one way of doing it is by saying, if you do not conform you are going to pay for it'. They also pointed out that being more robust in enforcement meant that financial institutions were beginning to take the regulator more seriously. The asset manager told us that regulators 'don't just need back-bone, you also need bite: In terms of how the culture of the regulator is changed, is that they have much more bite. Back bone [which is one of the values of the FCA] is not sufficient, in order to be taken seriously you need to have bite. You can certainly have back bone as you ensure the regulation is produced, heard clearly and you can patrol it, but in order to make sure people listen to you, you need to be able to put out sanctions and penalties'

**Stronger enforcement action:** There was acknowledgement by both consumer and industry stakeholders that the FCA needed to take stronger enforcement action against misconduct. The level of fines levied by the FSA was widely viewed as inadequate. The FSA had proved too reluctant to take action against individuals. However, there were some complaints from the industry about the level of fines and how there seemed to be some competition within the FCA as to who could levy the largest fine.

**Lack of durable cultural change:** Consumer stakeholders were concerned that with Martin Wheatley's departure, the FCA could slip back into the approach taken by the FSA. There was a concern that those at mid-levels within the FCA could see Wheatley's removal as an implicit signal that they should rethink the strategy of being tough on the banks. Examples cited of this included the scrapping of the FCA's review of bank culture and the introduction of a deadline for PPI complaints. As one person said of the culture in regulators generally 'it is a civil service with a civil service mentality: do your job, keep your head down, don't stick your neck out unless your boss and bosses boss have demonstrated a willingness to stick out their own'.

**Variable quality of staff.** A consistent theme among many stakeholders we spoke to was the variable quality of the staff at the FCA. One regulatory consultant told us that the FCA has 'a terrible culture' and that they 'recruited people who couldn't cut it at banks'. Others were subtler in their views: 'Regulators have some high quality individuals, but they are only in pockets. The result can often be the 'C team going up against the banks A team'. This can result in a situation of incompetent [staff] who don't know they are incompetent'. The CEO of a smaller bank echoed this sentiment point out that you can 'find handful of really good people (in the FCA). But its bench strength [is] lower than the non-regulatory environmental'.

A regulatory official in a bank explained how there were concerns that their regulators often did not have the degree of experience with their business that they had in the past: 'We have now some concerns about the knowledge and experience of the people at the regulator, we now see what we would perceive to be junior staff, high turnover of staff, it worries us from the perspective that we spend a lot of time to educate them on our organisation, and it feels like it is a continuous process because they are not retaining knowledge or staff. This is especially true for the FCA...Before it was different'.

There was a concern that the split between the PRA and the FCA had further decreased quality of personnel at the FCA. One regulatory consultant explained that 'all good people want to be in the PRA, all the dobbins went to the FCA.' Another regulatory official echoed this view, pointing out that 'those with talent did everything they could to go with the PRA'.

This lack of high quality staff in the regulatory process meant that regulatory officials may not ask the right questions of banks, and they often rely on box ticking processes rather use their judgement. An industry stakeholder pointed out that 'when you are dealing with people that are skilled and they understand the firm, they ask you the right questions. If they are not they ask you a stack of questions, which they may contain some of the right questions or may not. So the effort on the firm part is disproportionately high when you are dealing with those that do not have a clue'. This was echoed by another regulator who explained that 'we have seen a naivety about the questions they ask ... they seem to be unsure and the questioning seems to be disproportionate, which is a sign of lack of experience'. Another regulatory official in a large bank said that he was concerned that sometimes regulators would 'bring a boy to a knife-fight'.

The final concern is that increased demand for regulatory officials within banks had driven significant levels of turn over. One person we spoke with said that 'the layer below the executive board was very lumpy and people were always looking over their shoulder or for a career outside the regulator'. A regulatory official pointed out that 'the staff turnover is very high. So if you have had staff covering you as a firm for more than 2 years, you are doing well! If you are in a job less than 2 years you cannot really demonstrate you can do a job. But you do not want to stay more than 3 years, otherwise it shows that you cannot make a move'. Turnover driven by regulatory officials moving into industry has increased in recent years as Operational Risk Officers have proliferated, and increased in numbers in banks, so have Regulatory Compliance Officers, who are the highest paid resource in the industry presently. This is due to extensive rules that require to be



interpreted (by Regulatory Compliance Officers) and people (ie. Operational Risk Officers) need not only to interpret the rules but also to monitor that people do their job properly according to the rules’.

**Too much box-ticking.** According to some, the FCA relied on what one person we spoke with called a ‘quagmire of tick-box processes’ or an ‘expanded nightmare of tickbox compliance’. Some examples which were mentioned were the 650 page mortgage market review, and the overly complex documentation around the senior management regime. One regulatory consultant we spoke with compared two sets of documents prepared by the PRA and the FCA on a similar topic – the FCA documentation was significantly longer, much more complex, and far more difficult to understand.

Some people we spoke to were concerned that due to the number of relatively inexperienced staff engaged in supervision, they would often rely on standardised processes rather than using their own judgement. One regulatory official in a bank explained: ‘The analogy I like to use: Once upon a time I was a credit analyst and when I started I had no idea about how to be a credit analyst, so I wrote everything I knew about the credit hoping that in there I had captured the real risk and that my boss could find it. Whilst when you learn the job you just write one sentence’.

**Deep seated culture of box-ticking.** Others were more concerned that staff who were too familiar with the tick box approach to regulation had not learned to accept ideas about judgement. One ex-regulator we spoke with told us that ‘people that grew up with that (tick box) approach are now finding the fact that we do not live any more in that world. So there are people inside the regulator, and outside the regulator that really cannot get around to the new approach’.

**Lack of empowerment for frontline staff.** Some stakeholders we spoke with pointed out that concerns about career mobility within and outside the regulator meant staff were more likely to follow the rules to show that they had done everything correctly – even if it was not the most effective way of doing things. One person we spoke to told us that ‘It was difficult to empower frontline staff in the regulator to innovate. It was much easier for them to become box-tickers than risk taking a career limiting decision. Even in policy proposals such as the Mortgage Market Review the FCA had created paperwork to give the industry security. There was a deep-seated culture of box-ticking. This demand also came from the industry as they wanted the regulator to tell the industry what the industry should tell their staff to do’. Consumer groups acknowledged that although the FCA did indulge in tick-box regulation this activity was often driven by an industry which demanded ‘certainty’ about how it should behave to meet regulatory requirements in all possible sets of circumstances. Too many in the industry regarded the regulator as the only guide to acceptable behaviour.

Ultimately this focus on tick-box processes meant that banks felt that they were being diverted from core processes. The CEO of a small bank told us that ‘Effort filling out forms doesn’t add to a better, less risky business or better customer experience’.

**Lack of clarity.** Another concern mentioned by a number of the stakeholders we spoke to was a lack of clarity from the FCA. One bank official we spoke with told us that the ‘FCA is lacking clarity ... because you cannot define conduct ... it is sometimes not a fair comparison between FCA and PRA. PRA speaks in numbers ... we want that capital ratio met by then’. [For the FCA] ‘It is really, really, hard, they have a rule book ... but they do not tick to them ... it is too hard. Ticking to the rule book doesn’t stop bad conduct ... It is too difficult and resource-intensive to tick to the rule book, but if something bad happens, you can say the rule was there’. Another bank official echoed these concerns, pointing out the difficulty in articulating what

good conduct looks like: 'We expect different conduct, but the trouble is articulating exactly what it looks like.' A consumer group told us that principles-based regulation was 'OK as an idea. The problem was that no one knew what on earth it meant in practice.' The FCA was also facing pressure as 'the industry didn't want principles-based regulation, it wanted to be told what to do.'

**Unclear regulatory requirements.** There was also concern that the regulatory requirements or expectations the FCA set for firms to comply with could be spread out across numerous publications, including the handbook (including principles, rules and guidance), thematic reviews, Dear CEO letters, statements, communications, briefings, 'treating customers fairly' publications, review reports and industry produced guidance. It was noted that spreading these out across multiple and occasionally quite old publications could pose particular difficulties for small firms. This could especially be the case if these publications were not available on the FCA website and had to be found on the old FSA site which lacked search functionality.

**Reluctance to use the new powers granted to it by Parliament:** The Financial Services Act 2012 which created the FCA had granted it a number of new powers. These included the ability to name and shame firms which issue misleading financial promotions, publish details of warning notices issued to firms, and ban or restrict the sale of financial products. It had also recently gained the power to order individual firms or a number of firms to operate a redress scheme. The FCA has only used the product intervention powers once, only established one formal industry-wide redress scheme and has published a few warning notices – but without identifying the firms or the individuals involved. As far as stakeholders were aware, it had never used its power to name and shame firms which issue misleading financial promotions. This was a significant missed opportunity as the whole point of Parliament granting the new powers was that they would be used by the regulator to strengthen the incentive for firms to pay fair redress and issue clear financial promotions.

**Hard to engage with and doesn't make use of market intelligence:** Consumer and SME stakeholders believed that the FCA need to make far better use of the intelligence it held to identify emerging risks. There was also the sense that the FCA was difficult to engage with and failed to take reports of misconduct seriously or to investigate them properly. It was said that the mantra which individuals reporting concerns heard from the FCA was that the issues they raised were individual complaints (which should go to FOS) rather than issues of wider concern. Part of this probably reflected the lack of feedback received from the regulator but it was thought that this was also driven by a cultural attitude which failed to see the opportunity of meeting with consumers or receiving information about their experiences from consumers and whistleblowers.

**A culture of secrecy, leading to a lack of accountability:** We spoke with a number of whistle-blowers and others who had provided information to the regulator who were often frustrated by this culture of secrecy. The root cause of this secrecy was said to be restrictions imposed on the regulator by Section 348 of the Financial Services and Markets Act which provides a blanket prohibition on the FCA disclosing information received from firms, without the specific permission of the firm involved. There were also concerns from consumer groups that the regulator hid behind the restrictions and refused to disclose instructions it had issued to firms. This damaged accountability as stakeholders could not tell what instructions had been given to firms. In one case, a bank had told a consumer group that it was pursuing an approach to redress because it had been told to do so by the regulator. The regulator refused to disclose whether or not it had given the firm any instructions and if it had then what those instructions contained. Stakeholders noted that the regulator also refused to provide any sort of feedback about the action it would take in response to reports of misconduct from consumers, SMEs, firms or whistle-blowers. Whistle-blowers and SMEs we spoke with



stated that this attitude was very frustrating and fed suspicions that the regulator was too close to the banks. In one case, investigated by the Complaints Commissioner, the FCA had failed to properly investigate a whistle-blower's allegations, had asked the bank involved for its view and then reported that view back verbatim as though it had come from the FCA.

The lack of transparency also extended to 'agreements' negotiated by the FCA with banks such as those about the redress scheme for Interest Rate Hedging Products (IRHPs) which the regulator refused to disclose, even to the Treasury Select Committee. In a number of cases the FCA would also enter into agreements with firms instead of taking enforcement action, but refuse to publish details of these agreements. There has been no formal independent evaluation of this 'early intervention' activity.

Despite being given a specific power by Parliament to name specific firms issuing misleading financial promotions and publish details of the promotion, those reporting a misleading promotion to the FCA receive the following reply:

*"We are assessing the promotion in accordance with our team's case assessment procedures. Our processes require a determination of whether there is a breach and then an assessment of whether the issue meets our risk threshold. We then decide what action, if any, we should take. Due to confidentiality restrictions, we are unfortunately unable to provide you with any information as to what action we may have taken/take in this case, as we cannot divulge details of our action taken in respect of individual firms."*

The culture of secrecy damaged the accountability of the regulator as it was very difficult for politicians or the public to see what action it had taken in particular cases. The NAO has also raised the issue that as

the FCA is prohibited from disclosing information because of Section 348 this limited its “ability to reach a judgement on the FCA’s value for money,” as it “could not carry out a full assessment of the effectiveness of the FCA’s actions.” Some consumer stakeholders believed that it was strange that policymakers had made the NAO the statutory auditor of the FCA but at the same time were restricting the NAO’s ability to do an effective job.

**Lack of independent evaluation:** The FCA was seen as not having a culture of learning from its mistakes or of commissioning clear independent evaluation of its activities. These issues compounded the cultural issue identified above that the FCA might not always set out what it wants to achieve from its specific interventions, define what success looks like or monitor whether these impacts were being achieved. These views supported concern expressed by the National Audit Office that when trying to get redress for consumers the FCA “does not evaluate its chosen redress schemes formally, making it hard to assess whether schemes achieve their intended outcomes.” One stakeholder told us that “Internal audits were good at finding out what went wrong but could not do proper evaluation. This meant that when you are asking somebody to evaluate impact of something like Mortgage Market Review or the Retail Distribution Review, they are essentially marking their own homework. The FCA needed a strong head of strategy who was not looking for a job in the industry.”

**New objective to promote competition but most interventions focussing on the disclosure of information to consumers:** The FCA had been given a new objective to promote effective competition. Most stakeholders viewed this as an important and welcome new objective for the FCA and a key way of improving the way customers were treated. Some in the industry viewed this as an important way for ‘consumers to do their part, shop around, get competition working’. There had been a lot of activity at the FCA in terms of recruiting new people for their competition division and launching a number of market studies. For most, the jury was still out on whether this activity was effective. The market studies seemed to take a long-time and some consumer advocates were concerned that the majority of recommendations concerned changes in the way information was disclosed to consumers. Others viewed the FCA as too optimistic in its view that a few new entrants would transform the retail banking market.

**Internal Silos.** Another concern which the stakeholders we spoke with highlighted was the impact of internal silos within the organisation. One bank regulatory official told us that ‘we could have typically received 5 FCA reviews in one week, so it feels like they are not joined up, they are not speaking together. Why would anyone give 5 reviews to one organisation? If those people had truly spoken with our supervisor [at the FCA] and had understood our business, they would have known that some of the responses would have to come from a particular area of the bank, and by sending 5 reviews they would have put significant pressure on that area. So it does feel like they do not speak to each other . . . so from that perspective we could say that we see that they operated in silos’.

**Data overload.** One surprising issue which was mentioned related to how the FCA deals with data. We were told by some regulatory officials that the FCA has been influenced by the trend towards ‘big data’ and now regularly demands large amounts of data from the firms it regulates. The problem is that it is not clear whether the regulator actually knows what to do with that data or has the competence to effectively process it. One senior regulatory official in a bank pointed out that ‘there is a ‘rush to data’ now – the regulators are demanding huge amounts of raw data. The problem is that the banks have an analytic advantage. This rush to data has created an ‘analytic arms race’ – many of the quantitative skills which are

demanded are in short supply. It often results in there being more data than they know what to do with. This has created huge 'data lakes'. This official went on to point out that although was the data, there may not be the capability within the FCA to process it. At a New City Agenda event, Antony Jenkins (CEO Barclays 2012-15) noted the importance of regulators being able to access data:

*"Regulation is essentially a data problem. We have these rules and we have these behaviours – are they congruent? Where are the gaps? That is a data problem, and that can be solved by big data. That needs to be built in to the way banks and other industries are developing their systems, and then regulators need to be able to use technology to access that. The good news is we have the solution and the problem; the bad news is that we have to act if we really want to embrace it."*<sup>64</sup>

**Small players and new entrants find it difficult to engage with.** One consequence of the increasing complexity of regulation has meant that smaller players in the financial industry find it difficult to engage with the FCA. The CEO of one medium-sized institution we spoke with told us that 'I have to phone a call centre and go through a computer menu. You could have a wry smile and think this is mad, but it is worrying – the likelihood is that we are only seeing them once every four years. There is no willingness to have a relationship, or understand your business'. This meant that sometimes engaging with the FCA felt like they were 'talking into a vacuum'.

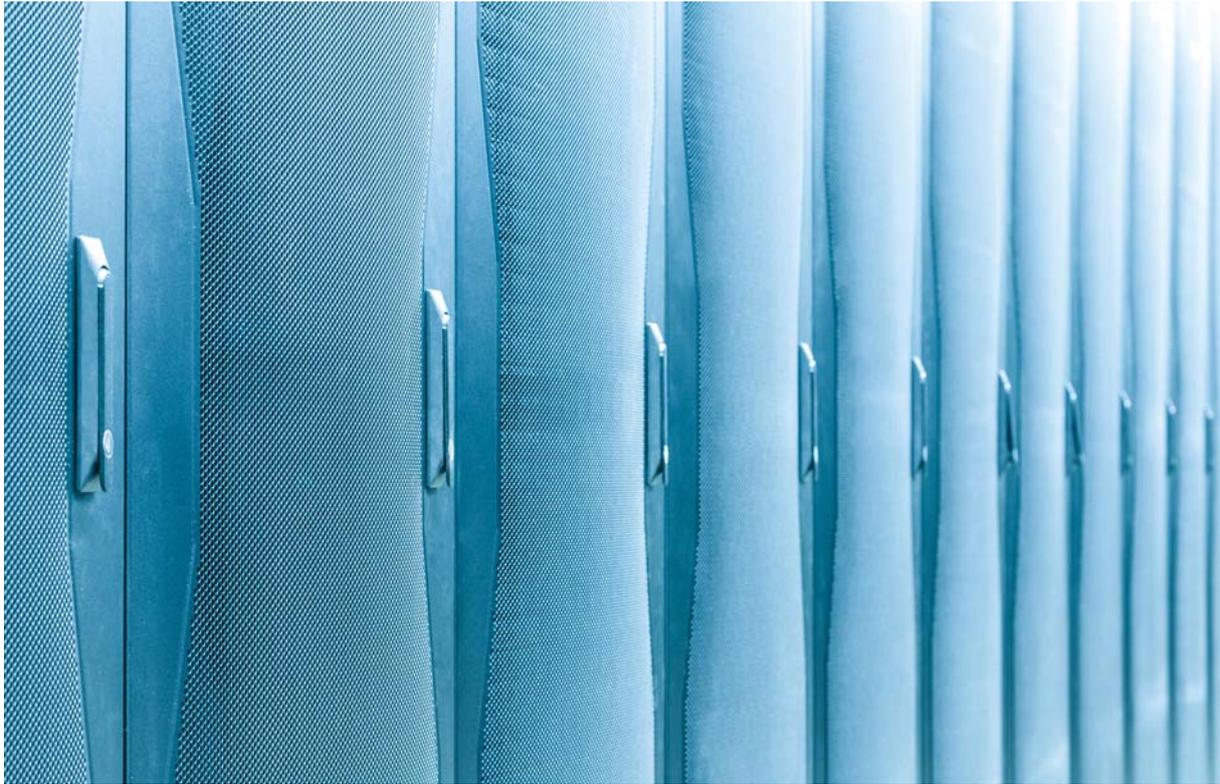
**Lack of independence and increasing pressure from Treasury.** The final concern which some stakeholders mentioned was the potential lack of independence of the FCA. One person we spoke with told us that 'the role of the Treasury has altered and there is a risk that the board will become an executive committee of the Treasury.' There was a belief among some that the regulatory independence of the FCA was being compromised and that the Treasury was influencing the work of the FCA through making speeches including a message that it was time for a 'new settlement' and removing the Chief Executive of the FCA.

## Both regulators

When speaking with stakeholders, we noticed a number of themes which cut across different regulators. There was a wide-spread sense that, following the financial crisis, there had been an increased regulatory burden which has increased complexity. This has made processes much slower, prompts a sense of fear, created a proliferation of administrative tasks and meant banks do things for the sake of doing them. This has created a thriving market for regulatory officials but some think it has got in the way of the relationship with clients.

**Increasingly regulatory burden.** Many of the regulatory officials we spoke with mentioned the increased burdens of regulation which they faced. One pointed out that 'the pace of change is very fast, if you look at the number of pages of regulations that have been published between 2008 and now you talk about tens of thousands of pages'.

This increased regulatory burden has been exacerbated by the existence of multiple regulatory demands. For instance, one asset manager told us how 'MIFID2 is asking for 84 different fields of information per trade.' These include 'The trader identity, his name, his address, his passport number ... It is becoming so invasive that you are wondering if this is in breach of the Data Protection Act'.



This increasing demand can also create a clash between different regulatory codes in some contexts. One person we spoke with told us that 'initially you saw the regulatory climate becoming more stringent with the introductions of new controls, bringing more transparency, more rules than principles based. This is very important in the UK, because it is more about principles based regulations, rather than rules based regulations, and this is very different in Europe, for example in France they are more rules based'.

**Slow processes.** One result of this increased complexity has been slow implementation of policy. One person we spoke with told us that 'at the FCA and at the PRA lead time of policy implementations is impacted by the bureaucratic procedures, and it is very slow. It is impacted by the excessive work load they seem to have compared to the resources available ...I understand the challenges they have in having to make sure that the processes are followed ...because you might rush into a policy that you have to unwind later, as we have seen, so that you have to come up with some supervisory discretion if the policy is too stringent ... and reverse engineer decisions'.

**Narrowing focus.** With the increased regulatory load, there was a concern that regulators would stop thinking more broadly and only focus on specific aspects which they were directly responsible for. One person told us that 'I think that you get into a mode where you stop wanting to understand what's going on and you become focused only on the small bit required. You want to stop understanding and taking risks, because it is better for you'.

**Fear.** Associated with this narrow focus is a sense of fear. One person told us that as an employee in a bank 'you are in fear because you feel you have got only downside, as an employee in a regulated entity, because you have the risk if you do anything. ... If something is done badly I could be attacked personally. If you do it well it's not that the regulator sees that you have gone out of your way, it's just what it is expected of you'.

Not being recognised for good actions which go above and beyond the regulations was also mentioned by another regulatory official in a bank. They pointed out that 'our impression was that these acts towards consumers which went beyond regulatory requirements could help us to garner support from the regulators, but the regulator seems to be not involved with these type of things but we would say that we want good outcomes from the consumers. And we were surprised we wouldn't find more support from the regulator for that type of approach.'

**Proliferation of administration.** Another implications of the increasing regulatory burden has been the expansion of administrative (rather than analytical) components of many jobs in the financial industries. One person we spoke with told us that 'there are a lot of bureaucratic activities, which make my job more similar to an administrator than to a financial analyst. Everything needs to be documented. ... I think the administrative component of the job in some instances can go up to 30-40%! And it's not getting easier'.

In addition to expanding the role of administration, some people in financial roles were concerned about how this impacted on their relationship with the client. One person told us that 'the regulator is ultimately trying to minimise, if not eliminate, my direct relationship with the client'.

**A hot market for regulatory officials.** One implication of the expanded weight of regulation has been to create a thriving market for regulatory officials. We were told that compliance officials are 'earning serious money, why? Because financial institutions need them. Their profile has changed massively post crisis. You need them because the regulator has more bite, because the rules have become more complex, and because the number of rules has proliferated. You need good ones, and you are prepared to pay'.

## Conclusion

In this chapter we looked at stakeholder perceptions of the UK financial regulators. We found that the Bank of England is widely respected by key stakeholders as a high quality regulator with significant intellectual fire-power and high quality people. However, it continues to be seen as somewhat cut off from the public. The Prudential Regulation Authority (PRA) has established itself as a respected regulator in the eyes of most stakeholders we spoke to. This is driven by high quality staff, focused regulatory scope, but perhaps most importantly its merger with the Bank of England. There were concerns that the organisations remained hierarchical and vulnerable to group think – although there had been welcome attempts at improved evaluation, welcoming academic challenge and enabling staff to write articles which did not accord with the 'house view' on the new Bank Underground blog.

Perceptions of the Financial Conduct Authority (FCA) were much more mixed. The most widely circulated story among stakeholders – in particularly the banking community – was that the FCA was staffed by people who could not make it in the banking world due to the lower level of pay offered. This lack of intellectual resource meant that it had a culture of rule following and box-ticking. Also it was frequently said that the FCA had over-reached its remit under Wheatley. The quote of 'shoot first, ask questions later' was frequently repeated and sometimes misinterpreted. However, many stakeholders recognised this story was not entirely true. The more informed stakeholders recognised real pressures within the regulator which included demands from multiple powerful constituencies, the existence of silos, too much risk adversity, and revolving doors

between the regulators and industry. There was acknowledgment that the FCA had needed to engage more with consumer groups and take stronger enforcement action and to some stakeholders these were welcome developments. However, the culture at the FCA continued to suffer from excessive secrecy, lack of responsiveness to feedback and an absence of independent evaluation. Finally, we found that there were a number of cross-cutting issues which stakeholders saw as shared between each of the regulators, including an increasing regulatory burden leading to increased box ticking which made doing business more cumbersome and potentially got in the way of relationships with the customer or client. There were also issues around increased complexity which have created increasingly slow and narrow processes, a sense of fear, the proliferation of administration and an increasingly buoyant market for regulatory officials.

## Enforcement action

A common problem throughout the history of bank and financial services regulation has been a failure to take action against senior executives for fraud and misconduct. From the South Sea Bubble, through Overend and Gurney to the Secondary banking crisis, Barings, RBS, HBOS and Northern Rock – many senior executives have managed to escape sanction. When it was established in 2001 the FSA was given an extensive range of disciplinary, criminal and civil powers to take action against firms and individuals who breach regulation. These included the ability to:

- Withdraw a firm's authorisation
- Prohibit an individual from operating in financial services or from undertaking specific activities
- Suspend a firm for up to 12 months from undertaking specific activities
- Suspend an individual for up to 2 years from undertaking a specific function
- Censure firms and individuals through public statements
- Impose financial penalties
- Seek injunctions
- Apply to court to freeze assets
- Seek restitution orders
- Prosecute firms and individuals who undertake regulated activities without authorisation

### FSA was not an enforcement-led regulator

But, in the run-up to the financial crisis, the FSA made little significant use of these powers. The FSA was at great pains to stress that it was not "an enforcement led regulator". The fines levied on banks were only a tiny fraction of the revenue the institutions had gained from misconduct. Consumer groups pointed out that firms got fined more for fixing the price of Action Men dolls

than they did for mis-selling financial products – the fines were just a cost of doing business rather than a credible deterrent against poor practice. The FSA failed to take action against individual executives for presiding over misconduct. Not a single senior banking executive has been sanctioned for mis-selling products to consumers.

Staff we spoke to said that the FSA “lacked confidence” and there was “a fear of bringing enforcement action against firms and a reticence to pursue an agenda of enforcement.” The FSA was scared that action against individuals would take a long-time and lead to extended challenges from their lawyers. We were also told that suggesting a very large fine – even in the tens of millions for a large bank would lead to the individual being laughed at. This attitude was compounded when Legal & General won a case in the Financial Services and Markets Tribunal which reduced the firm’s fine by 50% and criticised the FSA’s enforcement process. Even when the FSA ensured that firms named an executive responsible for particular activities such as complaints handling – it stated explicitly that it would not take action against the executive if their bank failed to treat customers fairly.<sup>65</sup>

## Seismic change following the crisis

Following the financial crisis we were told that there was a “seismic” change in terms of the FSA’s attitude to enforcement. The organisation felt that it had a strong moral and political mandate to conduct greater levels of enforcement action. There was strong internal pressure to get out and do more enforcement action. There was a significant increase in the number of actions taken against individuals – peaking at just over 50 in 2010. But this then declined and 13 individuals were sanctioned in 2014 and 22 in 2015 – although these numbers remain higher than the average of 6 individuals a year sanctioned in the run-up to the financial crisis.

Since the financial crisis and the LIBOR scandal a narrative was developed that it had been difficult for the regulator to take action against individuals – we were told that there was an accountability firewall and the trial was going cold halfway up the bank and before it reached the senior executives. This resulted in the recommendation by the Parliamentary Commission on Banking Standards that a Senior Managers Regime which would clearly attribute responsibilities to individuals. Senior Persons would know that they can be held accountable and subjected to enforcement measures if they fail to uphold those responsibilities. They also recommended the introduction of a ‘reverse burden of proof’. This would mean that if a contravention occurred in a part of the business for which a senior manager was responsible that senior manager would be guilty of misconduct unless he or she could show they took such steps to prevent the contravention as could reasonably be expected of a person in their position.

## Watering down of the Senior Managers regime

The Senior Managers Regime came into force for banks and insurers in March 2016. Firms had to provide the regulators with ‘Responsibilities Maps’ outlining the division of responsibilities among their senior management. The Government has also extended the Senior Managers Regime to other financial sectors. However, the ‘reverse burden of proof’ has been diluted and the onus is now back on the FCA and PRA to prove misconduct. The Government said that it would have

been disproportionate to apply the reverse burden of proof to smaller organisations like building societies and credit unions. The Chief Executives of the FCA and PRA supported this change – but some people we spoke to questioned whether they would ever have been able to give a different opinion in public. But this 'tone from the top' is nothing new. In 2000, Howard Davies, Chairman and CEO of the FSA said:

*When things go wrong, we shall look directly to senior management, whom we shall hold accountable. In the case of the failure of Barings, or the pensions mis-selling debacle, senior management have not been held directly accountable. Now we have a system of personal registration, where specified individuals at the top of the firm have clearly set out responsibilities for risk management and compliance, for which we hold them accountable.*

Therefore whilst important, setting the right 'tone from the top' in the regulator is insufficient to ensure greater action taken against individual financial services executives. Regulators need to have clear processes so they automatically investigate and consider taking action against individual executives when they have fine a firm. If regulators decide to not pursue a case against an individual then they should state clearly the reasons why they have decided not to do so. This will improve accountability and help ensure that after the next financial crisis we do not have the same old excuses trotted out by regulators and politicians about why those responsible have been let off the hook.

## Levels of fines

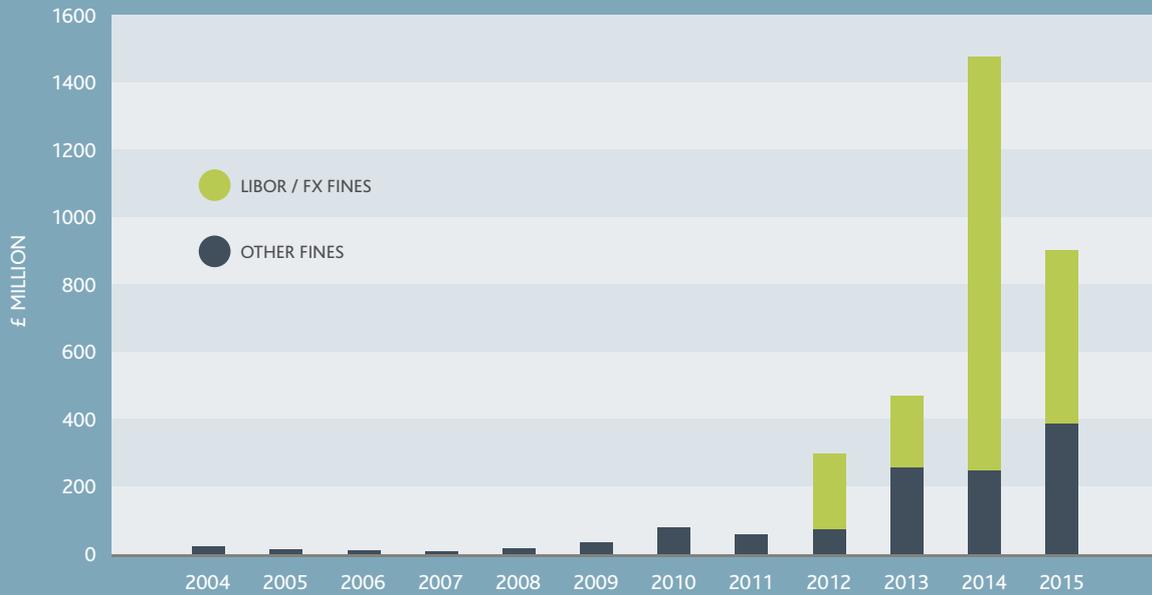
The figures for the level of FCA fines certainly show an increase over the pitiful amounts from the FSA. To a certain extent these were driven by the action taken against a number of banks for manipulating LIBOR and FX markets. This was accompanied by a significant increase in the average level of fines for other breaches from just below £1 million in 2008 to £24 million in 2015. This was partly due to a change in the FSA's penalty policy in 2010 which was designed to increase the level of penalties in line with its "credible deterrence" strategy.

In his 2015 Mansion House speech the then Chancellor said "simply ratcheting up ever-larger fines that just penalise shareholders, erode capital reserves and diminish the lending potential of the economy is not, in the end, a long term answer."<sup>66</sup> The BoE has estimated that the \$150 billion of fines levied on global-banks over the past five years translates into more than \$3 trillion of reduced lending capacity. Andrew Bailey, deputy governor of the BoE and the new chief executive of the FCA, said in 2014 that authorities in the US and elsewhere should consult regulators before imposing their fines. He said too-heavy penalties can have "real or potentially negative effects on the safety and soundness of the firms we regulate".<sup>67</sup>

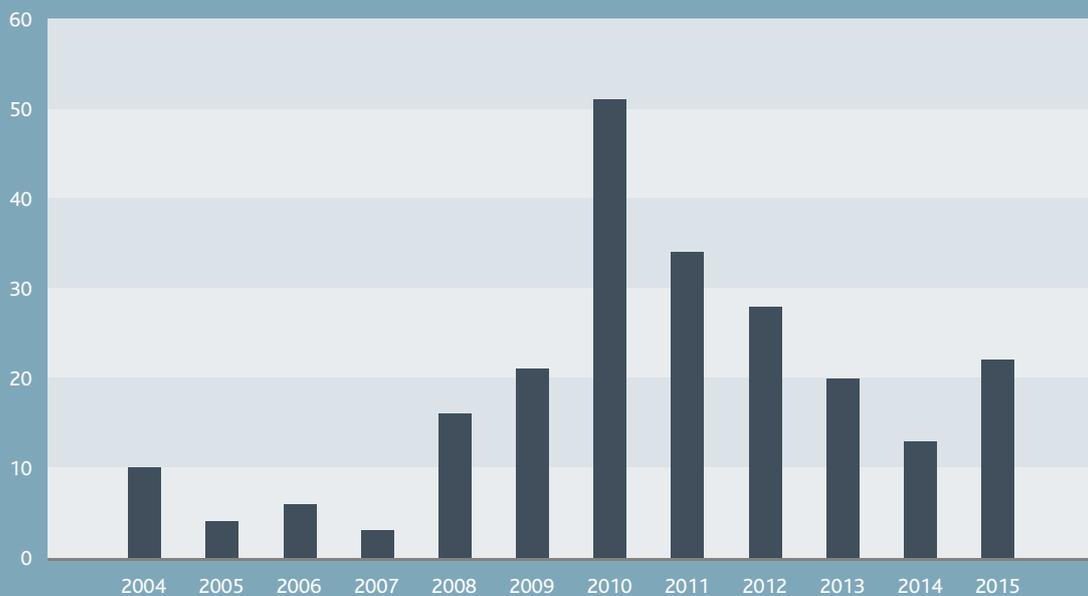
It remains to be seen whether the increase in FCA fines will be sustainable. The FCA's policy allows a significant element of discretion and this could be used to reduce the level of fines. Indeed since the start of 2016 the level of fines has shown a dramatic decrease with the FCA levying total fines

of just £9.9 million so far. The FCA will be consulting on its penalty policy later this year and has not yet stated how it will ensure that this consultation reaches out beyond the industry and takes in the views of the public.

## Fines levied on firms by the FSA/FCA



## Number of individuals sanctioned by the FSA/FCA







## Analysis of cultural change in the UK's financial regulators

In this chapter, we will bring together the detailed findings of each chapter to draw some wider conclusions which will drive the recommendations which are made in the following chapter.

There have begun to be changes in the culture of the regulators. These changes have been different in each of the regulators: within the Bank of England and the PRA, cultural change has been relatively disciplined and a top-down and comprehensive strategy has been transformed into specific actions. Within the FCA a plan for cultural change was initially set out internally, but the regulator has been somewhat blown off course by demands of various stakeholders. The new conduct regulator has been battered and bruised by leadership changes, constant restructuring and pressure from politicians.

Employees within the Bank of England / PRA as well as the FCA are broadly positive about the initiatives, but also note there are some important barriers to cultural change. It is not yet clear that these cultural change initiatives are making a significant positive difference on the frontline. Stakeholders also saw the Bank of England / PRA as having been more successful at changing its culture, while they have a much more mixed assessment of the FCA.

## Historical background

**Cycles of Regulation.** Since there have been financial markets, there has also been regulation. Looking at over 300 years of history of the UK financial markets reveals a cyclical pattern of regulation: Buoyant financial markets and increased financial innovation which, go unchecked, lead to a financial crisis. This sparks the creation of new regulation in the financial markets. Over time this new regulation is often slowly undermined or outflanked by the financial industry. This subsequently lays the grounds for a further unchecked boom and a further financial crisis. Politicians and financial regulators have been swearing that 'this will never happen again' and that next time 'senior executives will be held responsible' since at least the 18th century.

**Informal Regulation.** Another enduring aspect of regulation of the financial sector has been the role of informal modes of regulation. Hard law had been used at times to reign in the financial sector, but often more informal mechanisms were more important. The most well-known of these was 'the governor's eyebrows' – whereby the Governor of the Bank of England would allegedly communicate his displeasure with banks plans through a raising his eyebrows. Another example of this informal regulation can be found in informal pressure put on banks to reign in merger activities in the early 20th century and later to keep firms undertaking different activities - banking, mortgages, insurance and securities trading – in separate organisations.

**Learning from the past.** Many of the challenges which financial regulators face today could be seen as having precedents in the past. During the 18th century there was a wave of financial innovation which involved the creation of new financial instruments. These new financial instruments both provided an opportunity for the financial sector to rapidly expand. They also created new risks which were ultimately managed by greater centralisation of control in the Bank of England. The financial sector is facing similar issues today as FinTech companies create new financial instruments and business models which are entirely outside of the legislative framework. It is worth reminding ourselves that these waves of unchecked financial innovation have sowed the seeds for both economic growth and economic crises in the past and it may be no different in the future. Regulators and politicians have also always struggled to take action against senior executives in banks and other financial firms following fraud, misconduct and financial crises.

**Box-ticking and the pressure for a light-touch approach in the run-up to the financial crisis.** The liberalisation of the financial sector in 1986 meant that the sector moved from more informal regulation based on close relationships in the City towards more formalised regulation. This process of formalisation started the rise of what has come to be seen today as excessive box-ticking. There was also the centralisation of financial regulation. In 2000 there was a move from a range of different specialist financial regulators to a single regulator which covered many thousands of firms. The FSAs regulatory remit was increasingly large and its attention was stretched thinly across both consumer protection and financial stability. In the years immediately preceding the financial crisis there was a gradual weakening of the regulator's approach to the financial industry due to political pressure for 'light touch' regulation. The regulator was too permissive, too reactive and shied away from more vigorous enforcement action against the financial industry. They had a naïve faith that markets were self-correcting and would discipline banks with risky business models and assumed that market pressure would lead to senior executives acting in the interests of customers. Finally, the regulators tended to only focus on obvious outliers. This meant that they tended to overlook more systemic problems. Each of these factors combined laid some of the foundations for the 2008 financial crisis.

## Restructuring Regulation

**Beyond light-touch.** Following the 2008 financial crisis there was wider reflection about what exactly had gone wrong within the financial regulators. The initial wave of changes were in response to the failure of Northern Rock and led to the Supervisory Enhancement Program, which was then reinforced with Adair Turner's review in 2009. Both of these taken together represented an important departure from the 'light touch' approach to regulation which had dominated regulatory thinking in the lead up to the financial crisis. This was pushed further by the 2010 review which recommended greater focus on conduct of financial institutions and financial stability. This was ultimately enacted through the 2012 Financial Services Act which established a new regulatory landscape made up of the FCA, the PRA and the BoE.

**New regulators.** The changes introduced by the 2012 Financial Services Act largely focused on creating new structures (establishing the FCA and moving the PRA to be a subsidiary of the Bank of England), with a new scope of operation (such as focusing on conduct or prudential regulation) and new legislative powers. The LIBOR scandal also led to an increased focus on why individual executives had been able to escape sanctions. Regulators were subject to criticism for failing to take action against executives who had presided over misconduct and the collapse of RBS, HBOS and Northern Rock. New legislation was introduced to establish a new 'Senior Managers Regime' to hold executives to account for misconduct which falls within their areas of responsibility. There was also an awareness that moving to a more effective regime would take more than changes to regulatory structures, objectives and powers: It would require a change in culture within the regulators. There was a clear danger that the creation of the FCA and PRA might end up just being



a superficial rebranding exercise if the more formal changes were not backed up with more substantive changes to the culture of the organisations and the way they operate. It is interesting to note that when the FCA and PRA were launched, much of the 'tone from the top' was similar to the launch of the FSA over a decade earlier.

**A costly and complex regulatory system.** The creation of a new regulatory landscape was intended to introduce a more proactive and robust approach to regulation. However, it has also meant that financial regulation has become more costly, and complex. The amount spent on regulating our financial industries has risen significantly following the crisis. We now spend almost £1.2 billion a year on financial regulators. If we took into account the amount of resources which the industry devotes to regulation, the figure would be much higher. The complexity of regulation has continued to increase under this new regulatory structure. The rulebooks have grown in size significantly in recent years and measures of how much capital banks need to hold have become increasingly complex. There are now over 13,000 pages of rules, guidance and supervisory statements issued by the FCA and PRA. The regulator's scope continues to expand with the FCA taking over responsibility for regulating thousands of firms offering consumer credit.

## Changing Culture

We then conducted a systematic assessment of the actions the regulators were taking to change their culture. We examined the following areas:

- Leadership:** Changing tone from the top and establishing core purpose, values and objectives
- Processes:** Embedding the cultural change through reforms to processes such as remuneration, performance management, hiring, promotion and staff development
- Decision making:** How regulators brought other perspectives into their decision making processes through consultation, collaboration and introducing internal and external challenge
- Evaluation and accountability:** How regulators evaluated their impact, learned from their activity and were held accountable.
- Staff responses:** Perspectives of staff on cultural change and their impression of the barriers encountered.
- Measurement:** How regulators were measuring the progress of their cultural change programmes

**Cultural change in the Bank of England / PRA – the ‘One Bank’ programme.** Culture change has been undertaken under the auspices of the One Bank programme at the PRA and BoE. This is a top down change programme with the over-arching objective of creating a common culture in both organisations. It is based around a set of common values and has been implemented through changes to the way competence is developed at the bank, the structure of remuneration, the way people are hired, how performance is managed and promotion are distributed, concerns are reported, external and internal challenge is managed, leadership and collaboration processes take place.

**Culture change at the FCA – a fragmented process.** A similar process took place within the FCA. Following its founding, the organisation articulated some core cultural characteristics and values. Senior executives also made public statements about the importance of implementing a new culture within the organisation based on a ‘forward thinking’ and more ‘judgement based’ approach. This culture change has been enacted through a series of internal changes such as changes to competence development, the structure of remuneration, hiring practices, performance management and promotion, the internal and external reporting of concerns, leadership and collaboration. Unlike the PRA / Bank of England, many of these initiatives in the FCA appeared to be a little more loosely linked together. There have also been signs that the FCA risks being blown off course from implementing various cultural changes. The regulator was battered and bruised by leadership changes, constant restructuring and pressure from politicians.

**Staff reactions.** We found evidence that cultural changes within each of the regulators has been relatively well received by the staff. At the Bank of England, there was evidence that senior staff had adopted the new judgement based approach. However the acceptance of the One Bank strategy was more mixed – with many mixed responses as to how the strategic plan impacts on their jobs. We had more extensive evidence about employee reactions at the FCA. We found that staff generally felt energised by the new approach introduced by Martin Wheatley, and that the culture change initiative and values had been well communicated. Staff thought the regulator was friendly and their work had a sense of purpose. However there were concerns around the extent of bureaucracy and silos in the organisation, the organisation being overloaded, lack of opportunities for career progression, and internal and external pressure on the organisation.

**International comparisons.** We also examined how the FCA and PRA compared to regulators in nine other major financial centres – comparing the topics they discussed in their annual reports and the backgrounds of their senior staff.

## Stakeholder Reactions

**Bank of England / PRA.** Generally we found that stakeholders respected the Bank of England. They said it had high quality people, and that it was efficient and effective. However they also saw it as lacking transparency or even arrogant at times. The PRA was also widely respected by stakeholders. It benefited significantly from operating as part of the Bank of England – it was seen as having high quality people, being proportionate in its action, having a clear purpose and creating ‘no surprises’ for various organisations. Both the Bank of England and the PRA were still seen as vulnerable to group think and there was concern that they ignored external challenges to their policies. Sir John Vickers had laid out a comprehensive and well-argued view in a New City Agenda lecture concerning why the BoE was taking an approach to capital

requirements which was too soft. He explained that in setting the level of capital the Bank was assuming that it was "clairvoyant and extremely agile". The BoE disagreed with his views as it believed that its new supervisory framework would stop banks from taking excessive risks. Some viewed this as demonstrating an overconfidence in their own abilities.

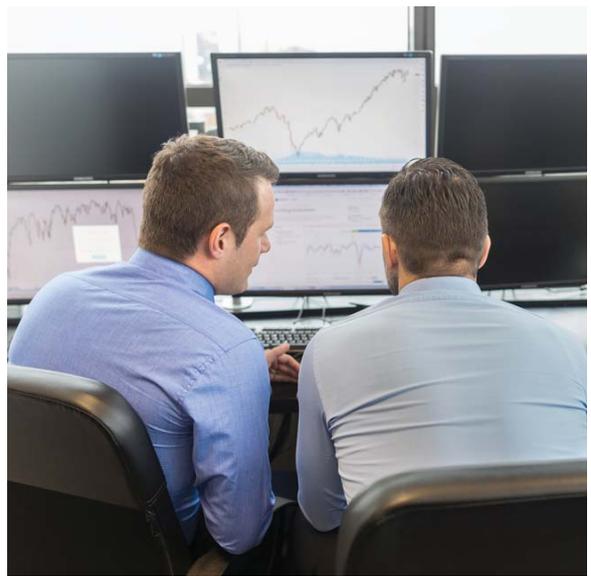
**More active engagement with the public.** The Open Forum which the Bank organised to get the public's perspective on reform was seen as valuable initiative but stakeholders thought the PRA and the Bank needed to do more to embed the process of consulting the public into their ongoing activities. It would be very disappointing if the Open Forum began to be seen as a one-off talking shop or PR exercise.

**FCA. Stakeholder assessments of the FCA were much more mixed.** They acknowledged that the culture had indeed improved, there was an increased willingness to engage with consumer groups and that enforcement action was stronger. However there were concerns about variable quality of staff, excessive box-ticking, a culture of secrecy, a lack of willingness to use new powers granted by Parliament, a lack of clarity, a lack of independent evaluations, internal silos and being overloaded with data. Smaller firms noted the difficulties of engaging with the FCA as they had to phone a call centre. There could be a potential distortion to competition as larger banks benefited from dedicated supervisory teams within the FCA which were available to answer questions. The FCA had scrapped its review of bank culture, which demonstrated complete insensitivity to the problems in the sector. There were also concerns as to whether the Board of the FCA would be independent enough to stand up to industry lobbying and political interference.

**Cross cutting issues.** There were also issues which cut across all of the financial regulators. The stakeholders we spoke to mentioned concerns with increased regulatory burden, increased complexity which have created increasingly slow and narrow processes, a sense of fear, the proliferation of administration and an increasingly buoyant market for regulatory officials.

## Conclusion

In this chapter, we brought together the over-arching findings of this report. Ultimately what we find is that UK financial regulators tend to operate in cycles – with a crisis leading to greater and more detailed regulation which is then undermined by firms and politicians eventually leading to another crisis. One result has been to create a regulatory structure which is more costly, complex and concentrated. Following the 2008 financial crisis there was a familiar attempt to increase regulators powers in order to protect a similar crisis happening again. This was enacted through changes to the structure and objectives of regulators and the powers given to them. To ensure these changes are not just symbolic, they needed to be translated into more sustained changes to the culture of FCA, PRA and Bank of England. We found that each of these organisations had made progress in changing their cultures. The BoE and PRA have been more consistent, whereas the FCA risks being blown off course in its cultural change. We found that stakeholders acknowledged this differential progress. While the BoE and PRA were widely respected, there were more questions for the FCA around issues such as external pressure, internal bureaucracy and organisational overload. In the following chapter, we will detail what this means in terms of specific recommendations as to how UK financial regulators can ensure they deliver the change of culture which is required to make the financial sector resilient and successful.





## Recommendations

In the previous chapter, we outlined the major issues which UK financial regulators face in their attempts to change their culture. We found that current attempts to transform UK financial regulators are part of a familiar pattern of cycles of regulation. But it has meant the financial regulation in the UK has become more costly, complex and concentrated. The reforms following the 2008 financial crisis has created stronger regulators. The financial regulators themselves have been variably successful in their attempts change their culture. The Bank of England and PRA have delivered a more consistent change initiative. The FCA began on a course of cultural change, but risks being blown off-course due to extensive external pressure. This was reflected in stakeholders' assessments of each regulator. While the Bank of England and PRA were well regarded among all stakeholders we spoke with, assessments of the FCA were much more mixed.

## Recommendations

Our analysis identifies a number of issues which each of the financial regulators need to address:

For the **Bank of England and the PRA**, increasing transparency and openness were highlighted by some stakeholders. One way to do this would be building on the success of the Open Forum by demonstrating that this is more than just a one-off PR exercise. The Bank needs to tackle group think by doing more to encourage internal and external challenge and independent thinking. There was also the need to ensure that the One Bank initiative makes a meaningful difference for employees at the Bank. The Bank will need to conduct a transparent and independent assessment of progress made with their cultural change programme.

The **FCA** and its new CEO Andrew Bailey need to develop a new comprehensive programme of cultural change, establishing the key purpose of the regulator and the metrics which will be used to measure success. Senior leadership need to demonstrate independence from politicians and the industry and provide support for frontline staff to take a more proactive approach. The FCA also needs to ensure it makes greater use of the new powers it has been given by Parliament and takes robust action in response to intelligence from the public and whistleblowers. Finally, it should learn more about the effectiveness of its activities by setting up an Independent Evaluation Office.

**Policymakers** need to recognise that excessive meddling can be counter-productive, reducing morale in the regulator and sending it in many different directions. Policymakers also need to acknowledge the limitations of ever more detailed regulation. There is an urgent need to reform the legislation which has allowed a culture of secrecy to develop in regulators by removing section 348 of FSMA. There remains a strong case for introducing a duty of care owed by financial services firms to their customers.

The **financial services industry** need to update their perceptions of regulatory agencies. They need to move away from generic criticism of regulators and suggest more focused and specific ways of improving regulations and regulators.

## Bank of England / PRA

- **Conduct a transparent and independent assessment of the progress made with their cultural change programme:** Through the *One Bank* initiative a comprehensive and detailed plan has been developed for cultural change in the Bank/PRA. This should identify the key metrics and milestones which are being used to measure the impact of the programme. This assessment and the overall progress with the programme should be audited and evaluated by the Bank's Independent Evaluation Office.
- **Embed its new judgement based approach:** Stakeholders felt that the Bank of England and PRA had adapted its culture well towards implementing a judgement-based approach to regulation, based on focusing on the big risks and senior management engagement. They will also need to acknowledge that their staff are subject to behavioural biases such as overconfidence, group think and social influence which may impact on their ability to exercise judgement when supervising firms.
- **Improve engagement with the public.** One of the weaknesses of the Bank of England is that it has

typically only engaged with very limited circle of financial institutions. This means it has been perceived as lacking a degree of transparency. It also means that it has been mainly influenced by the voices of a relatively small community of financial technocrats. This gives rise to dangers of group think. The Bank has taken some steps towards creating more open engagement through its Open Forum. It is vital that the Bank/PRA builds on the success of the Open Forum by making sure public consultation is part of an ongoing process rather than a one off PR event.

- **Encourage challenging and independent thinking.** The National Audit Office report on the Bank of England following the financial crisis pointed out that a lack of diverse and independent thinking was part of an ineffective response to the financial crisis. The Bank has taken some steps towards addressing this issues – such as establishing the 'Bank Underground' blog. More of these initiatives to create forums for independent thinking would be welcomed. There is a danger that as research agendas within the Bank become more centrally co-ordinated and managed that divergent research initiatives get driven out. There was also a danger that the Bank was overconfident in its ability to supervise large, complicated banks and was therefore disagreeing with the views of Sir John Vickers that capital requirements were inadequate.
- **Understand that bank misconduct can have consequences for prudential regulation.** There could be a tendency for prudential regulators to think that conduct issues are not their concern. This would be a mistake as it is clear that conduct issues can become so large that they have an impact on the stability of banks. Future problems in the Buy-to-Let market would be likely to stem from an interaction between conduct and prudential issues.
- **Reinforce that objectives had changed and no longer includes encouraging innovation or attracting banks to locate in the City:** The PRA no longer has to consider these issues and it is important that these points are reiterated to frontline staff.



## FCA

- **New CEO Andrew Bailey should institute a comprehensive programme of cultural change:** The new CEO needed to take responsibility for developing a comprehensive programme of cultural change within the FCA and be held accountable for progress.
- **Demonstrate independence from politicians and industry:** External pressure from politicians and industry lobbying had resulted in the regulator being blown off course in its limited attempts to establish a new culture. The new CEO would need to demonstrate that the FCA would resist pressure from politicians and industry for a return to the light-touch approach of the past.
- **Establish a clear sense of purpose:** The FCA had been given a strategic objective to “ensuring that the relevant markets function well” but among the stakeholders we spoke to there was often confusion about what the regulator was trying to achieve. The new Chief Executive would need to articulate a clear vision for what the FCA was trying to deliver for the public and how it can be achieved.
- **Spell out what success means and develop metrics to monitor whether it is being achieved:** The FCA was currently lacking a clear framework for measuring the impact its regulatory activities had on the market. Once the FCA was clearer about what it was trying to achieve it would need a clearer set of metrics to measure whether its activities were having the desired impact. The FCA would also need to state clearly what it was trying to achieve with any new change cultural initiative and have the progress made against it independently audited.



- **Reduce supervisory churn and retain staff.** One of the most frequent complaints from the industry was about the variable quality of staff within the FCA. An important contributing factor is that people at the regulator will often change jobs in pursuit of promotion or due to restructuring. What this means is that when regulators got to know an institution then they are shifted. This is often meant to increase independence, but it also lowers expertise leading to banks being asked to engage in box ticking exercises rather than focusing on a few important issues. The FCA should consider measures for ensuring that people do not continue to see the FCA as a 'parking spot'. This means harnessing the commitment to the organisation which is evidently there.
- **Senior leadership should provide backup to frontline staff.** During Martin Wheatley's term, staff felt the FCA was less cowed by the banks and was properly engaging with its mission. The willingness of senior figures to publicly back up staff was highly valued. This galvanised staff making them more committed to the institution. It is important in the future that senior leadership support staff in their attempts to hold industry to account. This tends to significantly strengthen morale and provide a sense of purpose in the organisation.
- **Make proper use of the new powers granted by Parliament.** The FCA had failed to make proper use of the new powers it had been given to regulate products, name and shame misleading financial promotions or order companies to pay redress. It seems a missed opportunity that the FCA still refuses to name the firm involved when it finds a misleading advert.
- **Reduce internal hurdles.** We were often told you would spend months having something signed off. This meant regulators felt like they were more engaged in dealing with internal bureaucracy than doing the work. One aspect of these internal hurdles were departmental silos. Often different parts of the FCA would not be engaged effectively with each other. This could mean that the same organisation had multiple FCA teams and investigations ongoing at the same time.
- **Improve engagement with the public, SMEs and whistleblowers and take robust action in response to their concerns.** Engagement could help improve trust, provide a valuable intelligence and offer an early warning system of potential risks and problems. It was unclear whether there had been any progress in the FCA's initial aspiration to develop a 'radar' to deliver real-time information on risks to consumers. Once information had been received it was important that robust action is taken in response. All too often people we spoke with thought that their reports, certainly initially, were not being taken seriously.
- **Better access to knowledgeable supervisors for medium-sized businesses and challenger banks.** Many medium sized institutions were frustrated about being directed to call centres when they had regulatory questions. There needs to be a better matching of regulators to institutions. This means medium sized financial institutions will not feel like their concerns were being lost in a call centre. Project Innovate was seen as a good example of improving the accessibility of the regulator.
- **Be more transparent.** The FCA was far too secretive which damaged accountability and fed suspicions that it wasn't always working on behalf of the consumer. The FCA needed to be far more open about what it was investigating and instructions it had given to the industry. It also needs to provide greater feedback to whistle-blowers and others who report problems. The FCA needed to be built on a presumption that information would be disclosed unless it would damage the public interest. This could be a big challenge for Andrew Bailey – whilst the public may be content to have capital requirements for banks negotiated in secret they are less comfortable when the conduct regulator enters into secret agreements with banks.

- **Build on successes.** The supervision of peer-to-peer lending was seen as being based on a genuine attempt to understand and support new innovative business models. Regulatory activity in the payday lending sector had also led to positive improvements. In these sectors the FCA had enjoyed clear political support, had shown a willingness to understand and analyse firms' business models and take strong action.
- **Develop a greater balance between sanctions and rewards.** One of the greatest frustrations expressed by the regulators' employees, as well as by employees at the regulated institutions, is that there seem not to be any celebration of good practices. To create more balance the regulator could design a reward mechanism, to celebrate best practices both internally, within the FCA, and externally in regulated entities. This could help shift away from a bureaucratic culture towards a more meritocratic one, where success is celebrated.
- **Understand what happens on the frontline and involve staff in the process of defining and implementing cultural change.** We saw that the FCA had initially got the tone from the top correct. However, what was less clear was how this was communicated throughout the organisation and the material difference it made on the front line in the organisation. This led to the danger of a disconnect between what is happening on the front line and the intentions of senior management.
- **Be wary of extreme risk aversion.** There seemed to be a tendency within the institution to avoid potential risks at all costs. If firms were to be encouraged to take risks then the regulator also needed to take risks and develop new approaches. Regulators tended to comply with processes and procedures rather than focusing on the issues which mattered. Regulators tend to have an inbuilt risk aversion – and this is right. However, excessive risk aversion can mean that many initiatives are not taken forward and get lost in bureaucracy.
- **Take an updated approach to big data.** Currently the FCA seems to be demanding large amounts of data from firms, however it is unclear whether it has the capacity to meaningfully analyse this data. The FCA needs to consider whether it has the right skills mix and whether new kinds of quantitative skills are needed to undertake this work.
- **Challenge the orthodox theory which leads to attempts to increase competition solely by disclosing information to consumers.** The FCA had been given a new objective to promote effective competition and had conducted a number of market studies. However, the policy outputs from these studies and other inquiries by the Competition and Markets Authority seemed to be dominated by measures relying on disclosure of information to consumers. It was noted by consumer representatives that redrafting disclosure documents and other information solutions have had a very limited impact on competition in the financial services industry but that this did not seem to be taken into account by the FCA or the CMA.
- **Develop genuine competence to understand and regulate culture.** As the FCA has sought to extend its focus on conduct, it identified bank culture as a priority. However it then scrapped its review of bank culture and it remains uncertain whether the regulator has a strong and focused enough competence in this area. If the FCA hopes to measure culture, it should ensure it has staff who have expertise in this area and it has a centralised competence in understanding culture. It should publish a transparent assessment of progress and not rely on the Banking Standards Board. It shouldn't franchise this vital work out to the industry.

- **Take strong enforcement action against senior executives responsible for misconduct.** After a burst following the financial crisis the number of individuals sanctioned by the FCA had gone down. Given its new powers under the Senior Managers Regime, the FCA should have a presumption that every time a firm was fined the FCA should also take action against the senior manager responsible. If it fails to do this it should clearly state the reasons why it has decided to drop the case.
- **Understand regulators behavioural biases.** The FCA had begun to undertake work examining how consumers behave. It needed to acknowledge that staff working in regulators could also be subject to behavioural biases. Just like we know that Doctors bias towards over-prescribing drugs, we might find that regulators have biases towards excessively complex regulation. This might involve conducting a more thoughtful analysis of the behavioural biases which shape regulatory behaviour and suggesting some 'nudges' which might ensure that unhelpful biases do not take over.
- **Set up an independent evaluation office within the FCA to ensure greater independent evaluation and internal challenge.** The FCA is an organisation which is under pressure from multiple external constituencies. However, it tends to deal with this pressure through being guarded and not engaging in much serious reflection. The FCA should set up an Independent Evaluation Office, similar to the one which exists within the Bank of England.

## Policy Makers

- **Acknowledge limitations of ever more detailed regulation.** It is a natural reaction of policymakers to call for ever more detailed regulation in reaction to financial scandals and moral outrage. Policymakers needed to acknowledge that there were limitations to this approach and that this complexity added to cost and distorted competition. Policymakers needed to consider whether they were content with a system which costs more than £1.2 billion a year. Policymakers could consider introducing specific mandates for simpler financial regulation and commissioning more independent evaluations.
- **Reduce levels of meddling with regulators.** There was a perception among some staff that directions from Treasury could often undermine work regulators were doing. This would lead to staff often feeling demotivated and unsure about direction of policies. It also meant that the regulators could be blown off course. This created a sense of uncertainty within the broader industry.
- **Avoid political pressure for light-touch regulation.** We noted that the UK financial sector tended to have policy cycles where crises would beget stricter regulation which would slowly be undermined lead to a boom and then another bust. Politicians need to be mindful that a move towards lighter touch regulation is likely to be a fatal step towards creating another crisis.
- **Appoint Boards with a diverse range of views and experience.** There is a danger when boards are appointed from only one disciplinary background narrow agendas are likely to emerge and there will be little in the way of challenge. Policy makers need to ensure that boards have people from a mixture of backgrounds to ensure this does not occur.

- **Reform legislation which requires excessive secrecy and harms accountability.** Policymakers had put in place legislation which resulted in regulators refusing to disclose information. Section 348 of the Financial Services and Markets Act, puts a blanket restriction on disclosure of information by the PRA and the FCA. This damages accountability as regulators then entered into secret agreements with firms and refused to disclose these to politicians or the public. Politicians had also given the National Audit Office a role in scrutinising the value for money of the regulator but the NAO was unable to get the information it needed from the FCA due to the restrictions imposed by Parliament on the FCA.
- **Introduce a duty of care:** The clear trend had been towards ever more complicated and detailed regulation. To help avoid a tick-box approach to compliance, both within banks and the regulator, policymakers should consult on introducing a duty of care which would be owed by banks to their customers.
- **Consider whether continuing to grow the size of the regulators actually leads to better regulation.** One of the major directions of travel in the last 15 years has been to give the FCA ever larger scope and it will shortly be taking over responsibility for Claims Management Companies. Policy makers need to ask themselves whether continuing to grow the scope of regulation is an acceptable idea or whether it may be better to focus the regulatory agenda more clearly.
- **Ask what happens on the frontline.** The Treasury Select Committee frequently interviews senior executives at the regulator but lacks a process to gauge, understand and interpret the views of frontline staff. Policymakers should gain feedback from staff about culture and how they are influenced by the prevailing political environment. The TSC would benefit from commissioning a project which would interview a large selection frontline staff anonymously about the culture of the regulator and summarise its findings.

## Financial services industry

- **Update perception of regulatory agencies.** We were frequently told by bankers that regulators were the least intelligent and the most poorly paid in the sector. There is an assumption that if they were any good they would be working in a bank. This did not seem to be the case when we actually spoke with regulators. It is important that banks update their perceptions of regulatory agencies.
- **Take personal responsibility and don't franchise out responsibility for culture change to other organisations.** Improving the culture in financial firms will require sustained commitment from the leadership of these firms. This must involve establishing purpose and values, taking personal responsibility for progress and ensuring that effective controls are in place to investigate and confront misconduct.
- **Make specific proposals for improvement rather than generic criticism.** During our research we received much general criticism and frustration rather than specific proposals about the operation of the regulators. More focused and specific suggestions about the regulatory process would prove to be more helpful than generic criticism.

- **Stop complaining about tick-box regulation then demanding more boxes to tick.** We noticed large banks in particular would tend to move between pointing out problems with tick box regulation and then seeking out certainty by demanding very clear and formal regulatory processes. This meant that large banks were in many ways complicit with regulatory creep. Given they had significant regulatory resources, they were well placed to deal with these issues. However it did create problems for smaller players in the industry.



The Cyril Klein



## Background

This report was commissioned by New City Agenda. It was carried out by a research team at Cass Business School, City University of London. The team consisted of Professor André Spicer, Professor Jean-Pascal Gond, Szilvia Mosonyi, Zahira Jaser, Dr Emilio Marti and Hannah Petersen. The Cass team received extensive support from New City Agenda Staff: Dominic Lindley and Abbie Edwards. The research took place between October 2015 and June 2016.

The report set out to examine what the UK's financial regulators – the FCA, PRA and Bank of England – had done to change their culture following the 2008 financial crisis.

We began by drawing together a range of documentation which trace the development of UK financial regulation. We reviewed what went wrong with the culture of the FSA and how these failings contributed to the financial crisis. The next question which we were interested in was how policymakers and regulators responded to the financial crisis. We trace these changes and map out the new regulatory structure and approaches which have emerged. The results of this historical analysis are reported in Chapter one.

To understand the process of cultural change within the regulators we reviewed written documentation including annual reports, speeches, staff handbooks and staff surveys. We also conducted interviews with current and former staff at the regulators. We had hoped that the regulators would cooperate by arranging interviews for us with their staff. Unfortunately, after initially agreeing to cooperate they then changed their mind and were unable to facilitate this activity. Instead we used our contacts to interview a wide range of current and former staff. In Chapter two we lay out what action the regulators have taken to change their culture, what progress has been made and how staff have reacted.

In order to broaden our understanding of these change processes, we also conducted interviews with stakeholders from a wide variety of organisations. When selecting these stakeholders, we aimed to gain a view of most of the key stakeholder groups affected by financial regulation including representatives from the financial industry, business groups, consumer groups, investors and policy makers. In addition to the interviews, most stakeholders provided us with additional material such as submissions to policy processes, reports they had produced and other publicly available documents. We interviewed industry representatives from a variety of different sectors and sizes of firms. The results of these interviews form the basis of what is discussed in Chapter three.

The interviews with current and former regulatory staff and stakeholders were typically semi-structured and took place over about an hour. Almost all interviews were conducted face to face. An indicative sample of the questions which we asked staff at the regulators and stakeholders can be found in the boxes below.

## Questions for current and former staff at the regulators

### **Introduction**

- Could you please let us know about your personal background and current role?
- What difference in terms of culture did you notice in contrast with prior organisations?

### **Topic 1: Your organization's cultural context and the trigger events associated with culture changes.**

- What is the desired or 'official' culture?
- What is the actual or unofficial culture?
- Are there different cultures in different parts of the organisation? What are these?
- How does the culture affect your job?
- Is culture being measured in any way? How does this impact on you?

## **Topic 2: Cultural change initiatives at your organization**

### **2.1. Content and design**

- What cultural change initiatives are you aware of? Have you participated in any way? What impact has this had on you?
- What are the most tangible elements you are aware of?
- How do you see this culture change linking to other aspects of the organization (such as performance assessment, pay, and structure)?

### **2.2. Impact**

- What kind of impact or influence is the change/culture change programme having on your part of the organisation?
- What do you see as the main successes related to this initiative?
- What aspects have not worked out so well?

### **2.3. Barriers and enablers of cultural change**

- What do you regard as the main challenges or barriers related to culture change here?
- What are the main factors facilitating this cultural shift (if any)?
- What changes to your organisation's culture would enable you to do your job more effectively?
- What could politicians, the industry and other stakeholders do to support culture change within your organisation?

## **Topic 3: Cultural change within regulators**

- What are the benchmarks or best practice examples which are often mentioned?
- How does your own organization compare to other organisations you are aware of?
- What are your views on how regulation as a whole has progressed in relation to cultural change since 2008?

## Questions for stakeholders

### **Topic 1 – Your background and the role of your organisation**

- Could you please let us know about your personal background and current role?
- Could you please let us know more about your organisation and its purpose/mission?

## **Topic 2 – Cultural change in the regulators**

### **2.1 Background**

- What was wrong with the culture of the regulator prior to the financial crisis and how did this culture contribute to the failings of the regulator?
- What, in your view, is the desired or 'official' culture at the regulators?
- What, in your view, is the actual or unofficial culture at the regulators?
- Are there different cultures in different parts of the regulators? What are these?
- What are your views about the change of culture in the regulators since 2008?
- According to you, what have been the main forces driving cultural change in the regulator?

### **2.2. Impact**

- Could you describe the most tangible elements of any culture change programme within the regulators which you are aware of (e.g. cost, level of commitment/endorsement from the top, number of employees concerned by the change program, expected impact, performance assessment, pay, and structure)?
- What kind of impact or influence is the change/culture change programme having in the regulator?
- What are the main successes related to this initiative?
- What aspects have not worked out so well?
- What change have you noticed regarding how the regulators have engaged with your organisation?
- Have you noticed any difference between the culture of the Bank, PRA and FCA? If so, what are the main differences?

### **2.3. Perceptions of barriers/enablers**

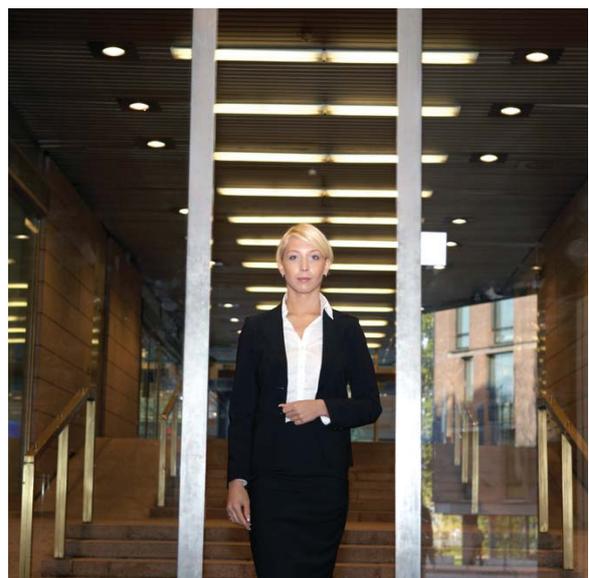
- According to you, which barriers, if any, prevent or inhibit cultural change in the regulators?
- According to you, which factors, if any, facilitate cultural change in the regulators?
- What could politicians, the industry and other stakeholders do to support culture change within the regulators?

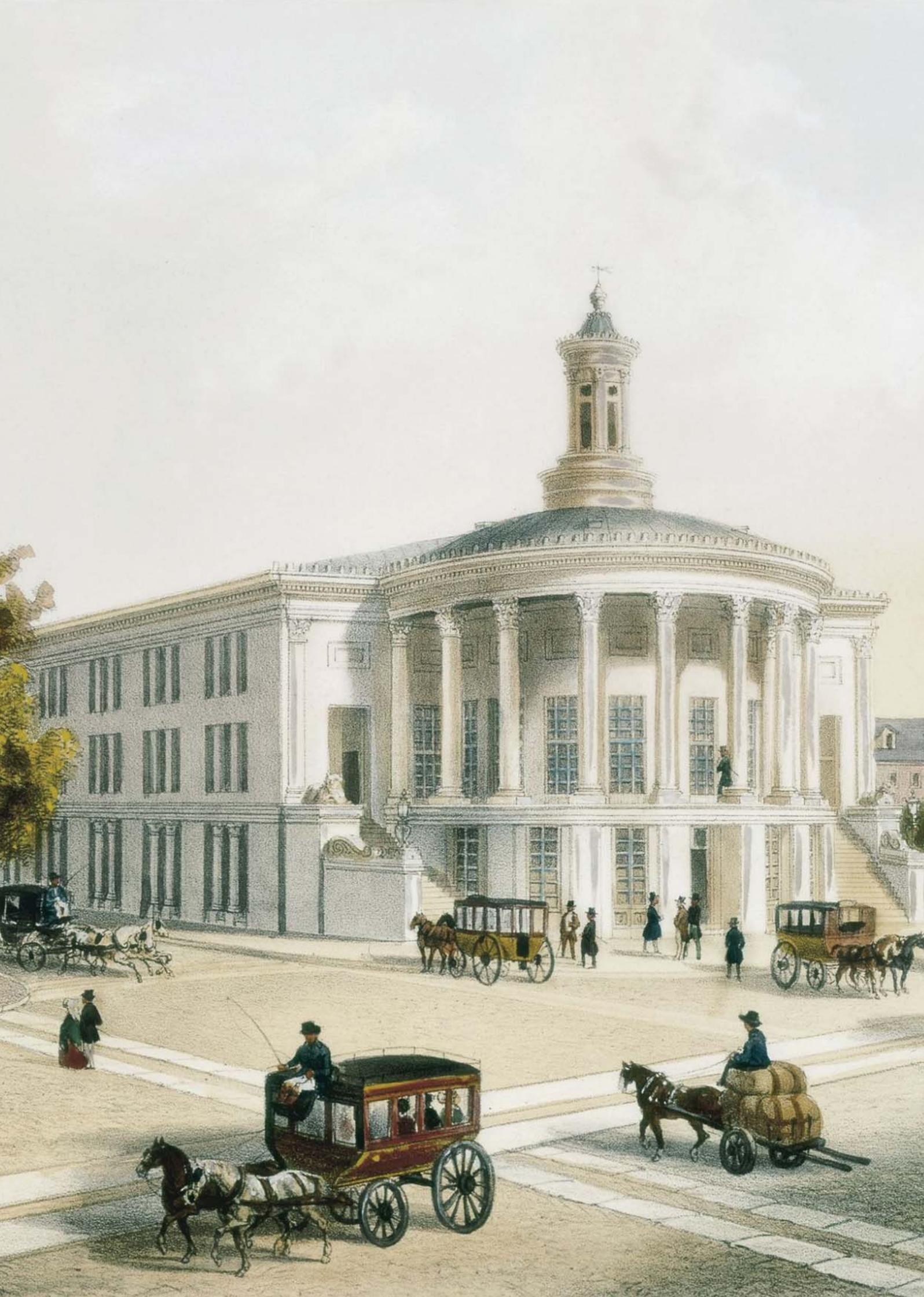
## **Topic 3: The role of your organization in relation to cultural change in the regulators**

- Did your organization support the process of cultural change at the regulator? In which ways?
- How do you see the role of your organisation in relation to cultural change?

#### **Topic 4: Cultural change within regulators – best practice**

- What are the benchmarks or best practice examples you have from culture change in regulators or other public or private sector organisations?
- Which regulator/organisation do you regard as a clear leader/laggard in this domain?
- How would you describe the culture which you would like to see within the regulator once the change programme is complete?





# Never-ending cycles - A history of financial regulation in the UK

## Early Regulation of the City of London

As long as there has been markets in the City of London, there has been regulation. The earliest recorded regulation of the city was a statute in 1284 which licenses the Court of Aldermen to license brokers. Regulation is typically prompted by bad behaviour in the financial markets. Following a financial boom and subsequent bust between 1693 and 1695, public trust in the financial markets plummeted and calls for legislative intervention increased. The Government passed an *Act to Restrain the Numbers and Practices of Stock Brokers and Jobbers* in 1697. This act was the result of an inquiry which found that

*'The pernicious Art of Stock-jobbing hath, of late, wholly perverted the End and Design of Companies and Corporations, erected for the introducing, or carrying on of Manufactures,...by selling their shares for much more than they are really worth..Thus,..the Management of that Trade and Stock comes to fall into unskilful Hands, whereby the Manufactures...dwindle away to nothing'.*

It found widespread forms of market manipulation and expressed concern that bad practices in the financial market would harm the wider economy. The Act required stock brokers and jobbers to be licenced, imposed a limit on their number, required them to swear an oath, placed a maximum limit on commission and required them to record all contracts and dealings.

Regulation also prompts attempts to lobby against it and undermine it from the City. The 1697 Act was the source of intense political lobbying by the City of London. Representatives of the City would often circulate pamphlets within Parliament defending the role of brokers. The 1697 act was allowed to lapse in 1707 following intensive lobbying by the City of London who were worried about the undue costs it imposed on brokers. Subsequent attempts to reinstate the act in 1711, 1719 and 1721 were all voted down on their third readings following intensive lobbying by the City.

In place of formal regulation, the City has promoted self-regulation. For instance following the lapsing of the 1697 act, the City appealed to its ability to regulate itself. This stands in stark contrast to other European centres where the regulation of financial markets was often heavily centralised. In London, the tradition of self-regulation remained a central principle. Financial markets in the City of London were largely regulated by the dense web of relationships between bankers in the City as well as through the Common law. The two major institutions of the early modern City of London – the Bank of England and the Stock Market – were both the creation of private actors and were subject to private regulation.

## The South Sea Bubble - 1720

Often following a period of self-regulation, another financial crisis emerges. In this instance it was the South Sea Bubble. This was the result of the founding of the South Sea company in 1711 – which was effectively a public-private partnership designed to carry national debt. The price of the company's shares rose tremendously following insider trading, investors borrowing using their shares as collateral to buy more shares, and use of company money to deal in its own shares. In 1720, the price of shares collapsed. Many individuals were ruined and the national economy was profoundly harmed. Notable losers included Sir Isaac Newton who concluded that although he could predict the motions of the cosmos he 'could not calculate the madness of the people'.

Politicians were keen to track down and punish the culprits. Lord Molesworth said in Parliament that he wanted the South Sea directors to be given the same punishment as parricides under the laws of Ancient Rome: sewn up in a sack and thrown alive into the Tiber. A former Chancellor of the Exchequer was charged with corruption and alongside some of the other directors was sent to the Tower of London. A portion of the directors' assets, including their recent land purchases, were confiscated.<sup>68</sup> The 33 directors were fined the equivalent of more than £3 billion today. The Rt Hon. Robert Walpole MP led the investigation but let a key witness escape and suppressed the inquiry to protect those who had accepted bribes and were close to King George I. Walpole's aim was to construct a political performance which gave politicians (and the public) sufficient opportunities to rage and storm, but which limited their ability to interfere in the workings of the financial system. Eventually Walpole was able to restore some property to certain South Sea directors, who remained important to the financial sector.<sup>69</sup>

The concern about widespread speculation prompted complains about moral standards within the City, and calls for legislation. The result was the passing of the Bubble Act in 1720 which imposed draconian penalties on those operating non-chartered companies. Although some think that this was passed in response to the events of the Bubble, others believe that it was actually a piece of protectionist regulation supported by the South Sea Company to stifle competition. These laws were only used once in their 100 years of existence, in 1825. During the remainder of the 18th century, there were hundreds of Acts of Parliament which sought to make money and financial instruments more secure.

## The Napoleonic wars, fake countries and bank failure

This cycle can be seen again during the 19th century. Between 1770 and 1810, there was a rapid financialisation of the English economy. In 1770, investors could only choose between 5 stocks on the London Stock Exchange. By 1824, 624 stocks were traded on the Exchange. Financial activity in the City was given added impetus by the issuing of debt to fund the Napoleonic wars. When these wars came to an end, the financial industries had to find alternatives to issuing Government debt. This led them to develop a bewildering variety of new financial instruments. The economy continued to globalise rapidly. Speculative investments in Latin America, including a fictitious country called Poyais, were particularly popular. This led to collective financial euphoria, poor standards of due diligence, banks making risky loans, financial innovations and the extension of the financial sector. It ended in crash in 1825 which saw the failure of six

banks in London and 60 county banks. It had a wider effects on the economy, with a doubling in the number of bankruptcies the following year. It even had an effect on the publishing industry, with the publishers of many romantic authors and poets going out of business – the publishers had paid their authors handsomely and had extended them credit on looser terms than banks.<sup>70</sup> Just as in previous financial crisis, this crash generated a series of moral warnings about the dangers of speculation and concern about ineffective regulation.

Following the collapse, there was an inevitable regulatory response. The Banking Acts of 1826 gave the Bank of England a monopoly over issuing notes under five pounds and allowed banks outside of London to operate as joint stock banks rather than partnerships. This privilege was extended to London banks by an 1833 Act. This led to the founding of 138 joint stock banks – although they tended to be relatively small operations. The concentration of issuing bank notes in the Bank of England was furthered by the 1844 Bank Charter Act. The Bank Charter Act along with the Joint Stock Banking Act of 1844 raised barriers to entry and imposed restrictions on expansion by existing banks mergers. This was later repealed in 1857, which along with reforms to reforms to company law between 1858 and 1862 which saw the creation of limited liability, fuelled a boom in the founding of new joint-stock banks as well as a wave of bank mergers.

## Overend and Gurney – Bank collapses and efforts to imprison bank directors

In 1866, the bank Overend and Gurney failed following its over-lending to the railway industry. A bank run ensued with crowds gathering outside its office at 65 Lombard Street. The directors of the company were tried at the Old Bailey for fraud based on false statements in the prospectus for the 1865 offering of shares. However, despite public anger, the Lord Chief Justice Sir Alexander Cockburn said that they were guilty only of 'grave error' rather than criminal behaviour, and the jury acquitted them.<sup>71</sup>

The move towards limited liability banking was accelerated following the collapse of City of Glasgow Bank (CGB) in 1878. Unlimited liability in the City of Glasgow bank meant that shareholders had to pay up to 27.5 times their initial investment to cover the losses. The press demanded the prosecution of the directors in order to 'restore confidence in Scottish banking'. The bank's general manager and one of its directors were found guilty of falsifying CGB's balance sheets and were given 18-month prison sentences. Five other directors were found guilty of publishing false balance sheets and were given 8 month sentences. This was only the second imprisonment of directors of a British joint stock bank. Despite this, the sentences were reported by *The Economist* to be 'inadequate' and 'leaving a lot of dissatisfaction behind, with questions asked as to why the defendants did not receive the harshest penalty available under the law'. But the press did think that the outcome would set new standards of honesty in the economy and recharge commercial morality. They thought that the guilty verdict placed a new obligation on bank directors to tell the truth and would thus prove 'a safeguard for good faith in banking' on which 'we are so much dependent for the stability of trade'.<sup>72</sup>

From the Victorian era until World War Two, there was a notable lack of formal changes to banking regulation. One major attempt to regulate banks was driven by concerns in 1918 that through the continued waves of mergers, the sector had become too concentrated. The Colwyn Report<sup>73</sup> concluded that the wave

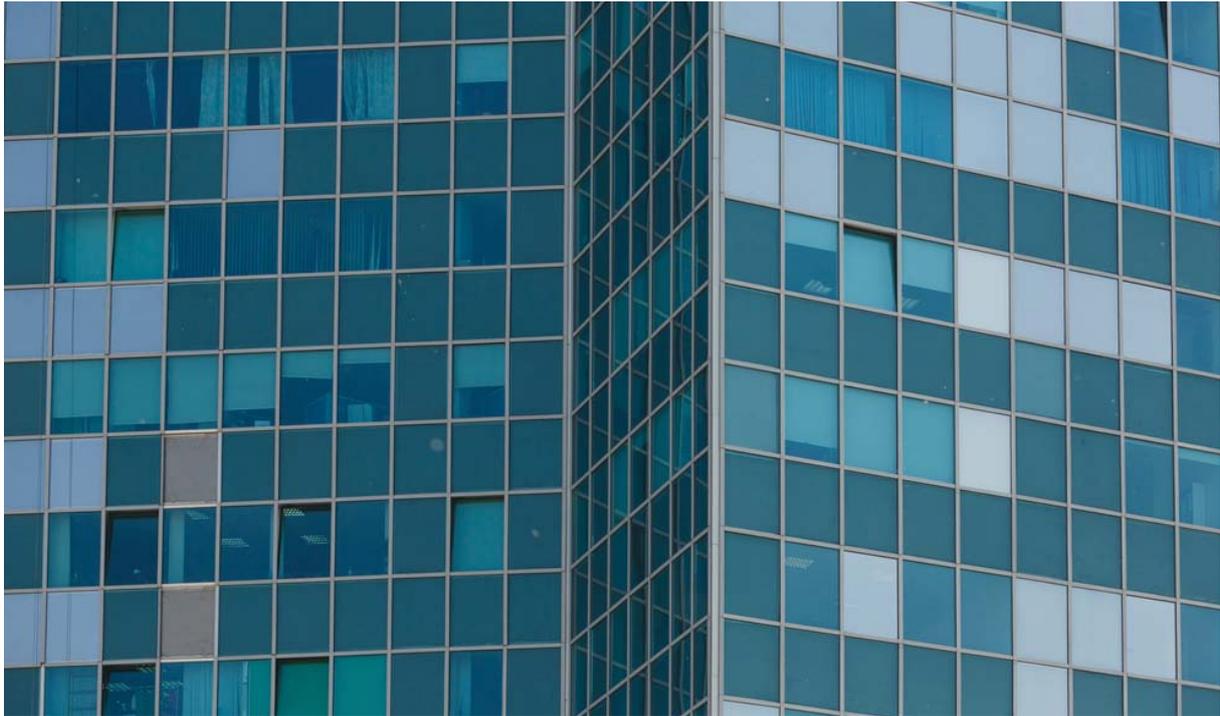
of mergers had gone far enough, and that further amalgamations were not advantageous to the wider economy. Although this recommendation did not lead to formal legislation, it did lead an often reiterated view on the part of the Government and Treasury that further amalgamation was not favourable. In 1921 a bill was proposed by Mr Walter Forrest MP which would have introduced a statutory annual audit of the accounts of all banks by the Board of Trade. In opposing the Bill the Financial Secretary said that it was 'quite unnecessary to commit the administration at this point to the employment, for this purpose; of a new series of Government officials. Nothing could be more undesirable'.<sup>74</sup> The Bill failed to pass the House of Commons.

These early instances of financial regulation are only the start of a long history of attempts to regulate the financial industry in the City of London. However, the pattern they follow is remarkably familiar. They show a clear cyclical pattern which is evident to this day. First there is mounting bad behaviour in financial markets which leads to a serious economic problems. This is followed by public moral outrage about the financial industry. The Government then steps in to impose legislation. This legislation is then slowly undermined or not effectively applied. This creates space for bad behaviour which then spreads and forms the basis for the next crisis.

## Post World War 2: The Secondary Banking Crisis, the Dark Side of the Moon, the Gower Report and the Big Bang

As we saw in the last section, financial markets in the City of London largely operated on principles of self-regulation. There was an ongoing cycle of booms, busts, regulatory initiatives and subsequent attempts to undermine or outflank regulation. By the late 1970s, this had produced a collection of largely single industry Acts. These were clustered around the Prevention of Fraud (Investments) Act 1958. They were supplemented by provisions of various Companies Acts. In some cases the requirements were administered by the Government department responsible for the particular act. Often this was the Department of Trade & Industry (DTI) – in the unit trust sector a 'vast body' of law and practice evolved which was never published and was known in detail only to DTI officials. For licenced securities dealers the DTI was criticised for lax enforcement and failing to remove a licence when a dealer was considered to be unsatisfactory. In other sectors, the requirements were administered by self-regulating bodies such as Lloyds of London or the Stock Exchange. There were also a number of professional bodies representing practitioners (such as the Council for the Securities Industry) who played some role in maintaining standards of investor protection – although some of these were considered to be discussion groups rather than regulatory bodies.

Although the City of London never had a statutory requirement for formal separation of different financial activities equivalent to the US Glass-Steagall Act, nevertheless the UK financial remained fragmented until the 1980s. Rules at the Stock Exchange prevented banks from becoming members. Building societies were restricted from competing with banks for the provision of consumer and commercial credit and the operation of the payment systems. Cross ownership between banks and insurance companies was discouraged by the Bank of England and the DTI. There were also practices which served to limit competition such as officially sanctioned cartels<sup>75</sup> and the convention that banks would not compete with building societies in the mortgage market.



Following its nationalisation in 1946, the Bank of England retained responsibility for bank regulation and the affairs of the City. Prudential regulation and supervision was informal – characterised as the Governor’s eyebrow – which would be raised if a bank was taking too much risk. In a report into the workings of the monetary system the clearing banks commented: ‘we listen with great care to what the Governor says to us at any time. He might give us a hint and we should not be likely to ignore it’.<sup>76</sup> Banks allowed the Bank of England to examine their operations although the BoE had no formal powers of direction to order banks to make changes. The secondary banking crisis of 1973-75 and the losses incurred by the Bank of England in supporting smaller banks led to the 1979 Banking Act which was intended to prevent a repeat of the crisis. The 1979 Act introduced a requirement for banks to be licensed to accept deposits from the public and gave the Bank of England powers to supervise bank’s ability to meet the conditions which institutions needed to meet to be authorised. The Act also introduced the Deposit Protection Board, guaranteeing 75% of a customer’s deposits up to a limit of £20,000. A two tier system of authorisation was introduced between Recognised Banks, which had established a good reputation and Licenced Deposit Takers (LDTs) which were new. The intention was that close control would be exercised over LDTs, with more informal measures being used for Recognised Banks.

The supervisory system relied on regular, close contact being maintained between the Bank of England and the management of the individual bank, combined with the submission of quarterly statistical returns to the BoE. In the early 1980s the Bank’s approach to supervision was based on being close to people, understanding the marketplace and having ‘hidden authority’. The BoE was respected by the banks and there was the impression that it knew what it was doing. What it said to the banks was taken seriously. The BoE had ‘Soft Power’. Its motto during the time was ‘Do Good by Stealth’. The BoE knew what was going on and would say to banks – ‘Don’t try and pull the wool over my eyes’. It would ask banks questions like ‘How can you be making so much money’. Understanding the business and knowing what questions to ask were seen as being very important for effective supervision.<sup>77</sup>

The collapse of Johnson Matthey bank in 1984 highlighted some of the weaknesses of the regime where supervisors relied heavily on the integrity of management of recognised banks and the BoE lacked analysis of the quality of loan books. The Bank concluded that: *'Licensed deposit-takers have been subject to a more rigorous regime of supervision, whereas the supervisors have relied heavily on the integrity and co-operation of the management of recognised banks. With most banks, this confidence has not been misplaced. But the banking industry has expanded rapidly, and its activities have diversified. Recognised bank status—as we have seen with Johnson Matthey Bankers—has not always guaranteed prudence and responsibility.'*<sup>78</sup> The response was the 1987 Banking Act which gave the Bank of England extra powers and ensured that only authorised institutions could accept deposits. Over time the regulatory system has moved more towards greater attention to the law and individual rules. This placed additional pressure on regulators to follow due process. Banks were also more willing to use legal protections and more likely to challenge regulators.

There were a number of financial scandals in the late 1970s and early 1980s which illustrated the shortcomings of the existing regulatory system for investor protection. The final straw was the collapse of investment management company Norton Warburg in February 1981 resulting in losses for investors including high profile victims such as rock group Pink Floyd, who lost all the money they had made from their album, 'The Dark Side of the Moon'. The Stock Exchange also investigated the conduct of a firm of Manchester stock brokers. Both of these cases highlighted that the current rules did not have provisions requiring the disclosure of conflicts of interest. In 1981, the DTI commissioned a Report by Professor Gower 'to advise on the need for new legislation'.<sup>79</sup> The Gower Report concluded that the current framework involved: 'complication, uncertainty, irrationality, failure to treat like for like, inflexibility, excessive control in some areas and too little (or none) in others, the creation of an elite and a fringe, lax enforcement, delays, over concentration on honesty rather than competence, undue diversity of regulations and regulators, and failure overall to achieve a proper balance between Governmental regulation and self-regulation.' The report's recommendations were based on the philosophy 'to provide the essential minimum of regulation needed to protect investors from being made fools of, but not to attempt the impossible task of preventing them from making fools of themselves'. The industry lobbied for the Gower proposals to be watered down. They called for more 'routine and effective criminal prosecution, principally against those institutions on the margins of London's financial community, whilst arguing for the continued practice of unsupervised self-regulation for those at its centre.'<sup>80</sup> As the Council for the Securities Industry put it:

*'We do not agree that the present system, which works well, should be replaced by a single comprehensive framework...Unquestionably the greatest weaknesses of the present scheme of regulation lies in the failure to deal effectively with commercial and financial frauds.'*

Following the report, the DTI prepared a white paper in 1985 which laid the foundations of the 1986 Financial Services Act. This was passed in November of that year and came into force in 1988.

These changes came into force alongside 'The Big Bang' – a dramatic reform of the rules of the Stock Exchange. This was prompted by Roy Hattersley's referral of the Stock Exchange's rulebook to the Office of Fair Trading under the Restrictive Trade Practices Act 1956. Following the 1979 election the investigation was dropped under the terms of an agreement between the then Secretary of State for Trade and Industry and the then Chairman of the Stock Exchange. Under the terms of this agreement, outside firms were permitted to takeover members of the Stock Exchange and to enhance competition minimum commissions were abolished. The distinction between 'jobbers' – who made markets in stocks - and 'brokers' – who executed

customer's orders – was abolished. The removal of this distinction, which had been seen as a primary method of protecting investors, increased the potential for conflicts of interest.

## The Dawn of Statutory Regulation

The Financial Services Act used a mixture of statutory regulation and self-regulation. It created a Securities and Investments Board (SIB) presiding over various new self-regulating organisations (SROs). Departmental responsibility initially rested with the Department of Trade & Industry (DTI) but was subsequently transferred to the Treasury.

The Securities and Investment Board (SIB) set the overall framework for the detailed standards of regulation, and consulted on and initiated policy objectives. Below the SIB were a number of Self Regulating Organisations (SROs); Recognised Investment Exchanges (RIEs); Recognised Professional Bodies (RPBs), and Recognised Clearing Houses (RCHs). The SROs were the most prominent of the regulators. Investment firms had to be authorised by an appropriate SRO if they wanted to conduct investment business in the United Kingdom. The SROs were funded and in part managed by the investment firms which belonged to them. For this reason, the style of regulation was known as self-regulation. At first, there were five SROs. But after 1994 there were three: the Securities and Futures Authority, the Investment Managers' Regulatory Organisation and the Personal Investment Authority. Prudential regulation of banks remained with the Bank of England and a new Building Societies Commission (BSC) was established to cover prudential and conduct regulation of building societies.

The regime established by the Financial Services Act of 1986 was the subject of a number of criticisms. The financial services industry claimed it was costly for industry and led to ever changing regulation which was costly to comply with. Even Nigel Lawson acknowledged that the regulatory system that emerged was far more cumbersome and bureaucratic than the Government had envisaged and 'paradoxically, the involvement of practitioners in the regulatory process, which was intended to avoid this, probably exacerbated it'.<sup>81</sup> Outside groups pointed out that the system tended to favour financial institutions over investors. Finally, some critics pointed out that the regime put in place measures which were too mechanistic with the result being significant risks were overlooked and regulators failed to act in a quick and timely fashion.

## 1989 – A new settlement

In 1989 a 'new settlement' was introduced by amending the Financial Services Act. Rules made by the SROs no longer had to be 'equivalent' to those made by the SIB and instead had to provide an 'adequate' standard of investor protection. The SIB used these new powers to issue 10 Principles and 40 Core (designated) Rules. This represented a 'striking change in the type of rules used by SIB. It was a move from detailed, specific rules to vaguer, more purpose-oriented rules, with little change in their substance.' The SROs also began to develop guidance as a direct result of the contradictory demands of certainty and flexibility. As one official explained in 1995: 'there is a tension in the desires of members – they want vague, general rules like the Principles and detest the detailed rule books, but they also want certainty and detailed information of what is expected

of them. Guidance is an attempt to resolve this tension.<sup>82</sup> The SIB also swung in its justification for moving from rules to principles:

*'In forming its initial rules SIB argued that detailed rules were necessary to ensure high standards of behaviour, given the competitive environment and actors who varied considerably in their competence and honesty. In introducing the Principles, therefore, the regulators were concerned to convince those who were worried about regulatory laxity that the Principles would be meaningful, and enforceable. As one official stated, "one of the aims was to sell the idea that rules did not have to be as specific as the old rule book to be effective." Paradoxically, the Principles are now used by SIB to defend itself against charges of overregulation.'*<sup>83</sup>

## The 1990s - Maxwell, Barings, BCCI and Pensions Mis-selling

The 1990s saw a continuation of the cycle of scandal and reform. Following revelations about Robert Maxwell's raid on his companies' pension funds, an investigation into the SIB was announced in 1992. The chairman of the SIB conducted a 'personal review' and published his conclusions in 'Financial Services Regulation: Making the two tier system work'.<sup>84</sup> This recommended the creation of a SRO to focus on the retail investment sector. The result was the creation of Personal Investment Authority (PIA) in 1994. This self-regulating organisation had sole responsibility for the retail investment industry. It governed the sale of life assurance, personal pensions, friendly society investments, unit trusts, investment trust savings schemes and financial services offered to members of the public.

The collapse of the Bank of Credit and Commerce International (BCCI) in 1991 led to criticism of the Bank of England and questions were raised about why the bank had not been shut down in the 1980s when evidence about its fraudulent activity first came to light. As early as 1982 one internal memo described BCCI as 'on its way to becoming the financial equivalent of the SS Titanic!'.<sup>85</sup> The Bingham report found that although fraud was highlighted by other parties the Bank of England did not investigate as it did not see itself in an investigatory role. Auditors failed to pursue evidence of fraud aggressively enough and didn't alert the Bank of England. The Liquidators of BCCI sued the Bank of England with the legal action continuing until 2012.

Widespread mis-selling of personal pensions began to come to light in the early 1990s – millions of consumers had been advised to transfer or opt-out of their occupational pensions and had suffered losses. In its evidence to the Treasury Select Committee, the Treasury said that 'firms simply did not abide by the regulatory rules'.<sup>86</sup> The remuneration arrangements for financial advisers and sales people were also seen as contributing to the scandal – advisers were paid commission and given specific sales targets they needed to meet in order to receive their salary. Reviewing pension mis-selling took over 8 years and resulted in £11.8 billion of compensation paid to consumers.

In 1994, the Treasury Select Committee started its own investigation into financial service regulation. The report found that there was a lack of clarity in the objectives of the Financial Services Act. There was a sense that self-regulation was the same as self-interest. There were also doubts about the cost-effectiveness of the regulatory system. Finally, there was a feeling that fraud was allowed to go unpunished.

The failure of Barings Bank in 1995 due to unauthorised trading led to a report from the Board of Banking Supervision of the Bank of England which was published less than 5 months after the bank collapsed.<sup>87</sup> Barings was regulated by the Bank of England and the derivatives trading section which caused the collapse was also regulated by the SFA. Recommendations of the report included that the Bank of England should have greater knowledge and understanding of bank's wider businesses and should ask questions about profitability, have more meetings with bank management and greater liaison with other regulators. The report also concluded that banks should have clearly defined lines of responsibility and accountability. This was partly based on the finding that rogue trader Nick Leeson reported to 3 different people and after the collapse each of them denied being his manager. In the years following the scandal, concern was expressed that regulators had failed to hold the senior executives at Barings to account for its failure.



## The Financial Services Authority – a single regulator for the financial sector

Immediately after the election of the Labour Government in 1997, the Rt Hon Gordon Brown MP announced wide ranging plans to reform the structure of financial regulation:

*'The existing arrangements for financial regulation involve a large number of regulators, each responsible for different parts of the industry. In recent years there has been a blurring of the distinctions between different kinds of financial services business: banks, building societies,*

*investment firms, insurance companies and others. This has added further to the complexity of financial regulation. The Government believes the current system is costly, inefficient and confusing for both regulated firms and their customers. It is not delivering a standard of supervision and investor protection that the public has a right to expect. We are therefore establishing a single, statutory regulator for the UK financial services industry with clearly defined regulatory objectives and a single set of coherent functions and powers.’<sup>88</sup>*

Scandals cited at the time which necessitated the reforms included the failure of Barings bank and the widespread mis-selling of personal pensions. There was a sense that senior executives in firms had evaded responsibility for these failures.

These reforms resulted in a proposed new regulatory landscape including an independent Bank of England, responsible for monetary policy and overall financial stability and a single combined prudential and conduct regulator - the Financial Services Authority (FSA).

In 1998, the Bank of England Act was passed. A key part of this legislation was to give independence to the Bank of England’s Monetary Policy Committee for setting interest rates. The act also transferred the regulation of deposit-taking by banks and banking supervision in general to the SIB (which would become the FSA) from the Bank of England. The Bank still retained responsibility for overall financial stability.

In 1998, the FSA was created. It took over the responsibilities of, and had powers equivalent to at least nine regulators. These were:

- the existing FSA (formerly the Securities and Investments Board);
- the Self Regulating Organisations (SROs): Personal Investment Authority (PIA), Investment Management Regulatory Organisation (IMRO), and Securities and Futures Authority (SFA);
- the former Supervision and Surveillance Division of the Bank of England (already transferred to the FSA under the Bank of England Act 1998);
- the Building Societies Commission;
- the Insurance Directorate of Department of Trade and Industry;
- the Friendly Societies Commission;
- the Registrar of Friendly Societies.

The staff of the separate regulatory agencies were transferred to become employees of the FSA at an early stage, mostly during 1998, even while their governing boards or commissions retained responsibilities under the existing legislation. The FSA entered into a series of agreements to provide services to these boards and commissions until the new legislation came into force.

## The Financial Services and Markets Act 2000

In 2000, the Financial Services and Markets Act was passed. This was driven by the need for new legislation which fitted with recent financial innovations, the increasing globalisation of the financial landscape, and

the dominance of large universal banks. The rationale for a single regulator also included the availability of economies of scale in regulation, the clarity of having a single regulator accountable for its performance against its objectives and allowing the regulator to resolve any trade-offs between these objectives within a single agency.<sup>89</sup> The Act created the tripartite framework: the FSA, Bank of England and HM Treasury. A Standing Committee on Financial Stability was established and chaired by the Treasury with representatives from all three arms attending.

The Act formally merged the nine different regulators together to form the FSA. On its passing the FSA became one of the most powerful financial services regulators in the world in terms of its scope, powers and discretion. It was established as a 'company limited by guarantee' and financed by the financial services industry through the payment of a levy. The Board set overall policy, but day-to-day decisions and management of the staff were the responsibility of the Executive Committee (ExCo). It was accountable to Treasury Ministers and, through them, Parliament (but operationally independent of government). It set the standards for firms that they must meet and could take enforcement action against them if they fail to comply. New activities included regulating mortgage lending, direct supervision of legal and accounting and actuarial firms, Lloyds of London brought into the FSA's new regime, new powers on money laundering, credit unions regulated for the first time and new powers on unfair contract terms. The FSA also took over responsibility for preventing insider dealing from the DTI.

The Act gave the FSA four objectives:

- market confidence – maintaining confidence in the UK financial system;
- financial stability - contributing to the protection and enhancement of stability of the UK financial system
- consumer protection - securing the appropriate degree of protection for consumers; and
- the reduction of financial crime - reducing the extent to which it is possible for a regulated business to be used for a purpose connected with financial crime.

In the course of discharging all its general functions, the FSA also had to 'have regard' to the seven principles of good regulation:

- the need to use its resources in the most efficient and economic way;
- recognition of the responsibilities of regulated firms' own management;
- proportionality between the burden, or restrictions imposed on a regulated body in relation to the benefits;
- the desirability of facilitating innovation in connection with regulated activities;
- the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom;
- the need to minimise the adverse effects on competition that may arise from anything done in the discharge of its functions; and
- the desirability of facilitating competition between those who are subject to any form of regulation by the Authority.

During the first few years of the FSA's operation there was the need to transfer staff from all of the different organisations into the new single organisation. A new management structure was established and new

people were arriving every month. There was also a need to align terms and conditions and remuneration arrangements. In the winter of 1998, FSA staff all moved into their new headquarters in Canary Wharf. The FSA developed what it called an 'integrated and risk-based' approach to regulation.

In its document – A New Regulator for the New Millennium<sup>90</sup> – the FSA set out that its aim was to shift to a regime which:

- was built on a clear statement of the realistic aims and the limits of regulation;
- recognised the proper responsibilities of consumers themselves and of firms' own management, and the impossibility and undesirability of removing all risk and failure from the financial system. A firm's senior management is responsible for its activities and for ensuring that its business is conducted in compliance with regulatory requirements;
- was founded on a risk-based approach to the regulation of all financial business which integrated and simplified the different approaches adopted by the current regulators
- operated a transparent new framework for identifying and addressing, as part of the regular planning cycle, the most important issues facing firms, markets and consumers. Each year the FSA will set out publicly the areas identified for priority attention – what it will describe as its regulatory themes;
- used the full range of tools available to the Authority under the new legislation including consumer education;
- switched resources from reactive post-event action towards front-end intervention – the FSA would have a 'bias towards proactivity' seeking to identify and reduce risks before they cause significant damage. This will include speaking out promptly and publicly on major issues, highlighting both good and bad practice among regulated firms and potential problems for consumers
- created incentives for firms to manage their own risks better and thereby reducing the burden of regulations – harnessing market forces and going with the grain of the market.

## The tripartite system – failed to tackle risks to financial stability

Responsibility for financial stability in the UK was shared between HM Treasury, the Bank of England, and the FSA, which together constituted the 'tripartite authorities'. The division of responsibilities between the tripartite authorities was set out in a Memorandum of Understanding (MoU).<sup>91</sup> The MoU stated that 'the authorities maintain a framework for co-ordination in the management of a financial crisis', and it delineated responsibilities for operational crisis management.

The Bank of England was primarily responsible for ensuring the stability of the monetary system. Its role was to oversee the financial system infrastructure which was considered to be systemically significant to the UK, with a particular focus on the payments system. The intention was that the Bank should be closely involved in developing and improving the infrastructure and strengthening the system to help reduce systemic risk.

Its role was to maintain a broad overview of the financial system as a whole. The Bank was seen as uniquely placed to do this, being responsible for monetary stability and having representation on the FSA Board (through the Deputy Governor - Financial Stability). But the financial stability work was not viewed as a priority within the Bank. The Bank cut back the number of staff working on financial stability, and its work began to be seen as just publishing a twice yearly 'Financial Stability Report' document. Bank officials were confident enough to say, in August 2007, just prior to the financial crisis the Governor said that everyone should remember 'a very, very key point, which is that our banking system is much more resilient than in the past.'<sup>92</sup> They added that 'It is not an international financial crisis, it's developments in spreads, which reflect I think a more realistic pricing of risk and that's to be welcome.'

The Treasury's role was to provide the overall institutional structure of financial regulation and the legislation which governs it, including the negotiation of EC directives. The Treasury should inform and be accountable to Parliament for the management of serious problems in the financial system and any measures used to resolve them. There was significant staff turnover amongst those in the Treasury working on financial services and responsibility for policy was moved twice in two years to different parts of the Treasury. In summer 2007, there was, intentionally, limited capacity on financial stability issues – a team of three people.<sup>93</sup> The strong global consensus at the time, of which the Treasury and Bank of England were part, believed that the regulatory approach and new methods of securitising debt had substantially reduced systemic risk in the financial sector.

The MoU also established a Standing Committee for Financial Stability – a monthly meeting of senior officials from across the Tripartite. The Committee largely focused on the financial sector's resilience to operational disruption, such as a terrorist attack. War games or dummy runs of a possible financial crisis were played out. In 2004, this included a major stressed bank – like Northern Rock – in difficulty because of its mortgage lending book; in 2005, it was a liquidity crisis in an investment bank – a re-run of Barings. The war games revealed the lack of a statutory resolution framework to deal with a failing bank. This was followed up by the Treasury, but not vigorously, as the risk of major financial instability was deemed to be low and therefore no new arrangements were in place when Northern Rock failed.

## A single Ombudsman and compensation scheme

The Act also established a single Ombudsman scheme - the Financial Ombudsman Service (FOS) and a single compensation scheme – the Financial Services Compensation Scheme (FSCS). The FOS brought together the existing alternative dispute resolution mechanisms in the financial services sector in a consolidated statutory scheme. This allowed consumers to address complaints to a single organisation with confidence that the scheme would have appropriate jurisdiction for their complaint. The Ombudsman's decisions are based on what is 'fair and reasonable' and the firm is required to accept them. The FSCS brought together the Investors Compensation Scheme and four other compensation schemes whose coverage included insurance, bank deposits and building society deposits. It would be financed by a levy on the industry, but would not be pre-funded – its levy would be designed to cover the cost of firms which had failed, rather than to build up a significant fund to cover the cost of future failures.



## Additional responsibilities for the FSA and pressure to pursue a light-touch and principles-based approach

Following the establishment of the FSA, there were some incremental changes which increased the scope of its operations. In 2003, there were internal changes at the FSA and senior management were determined that it would produce fewer consultation papers – keeping the number issued in a year below 20. This was achieved by consolidating a number of consultations into one big 300-page ‘Quarterly Consultation Paper’. They also revised their supervisory strategy and recognised the different emphasis of different institutions on wholesale and on retail issues. In 2004, the FSA launched the ‘Treating Your Customers Fairly’ (TCF) principles and announced that a key part of its strategy would be to move away from detailed rules and towards broad principles. The FSA aimed to remove around half of the content of its ‘Conduct of Business’ rulebook which applied to investment businesses. It also announced that it would rely more on voluntary industry developed guidance, which would be ‘approved’ by the regulator. Complying with industry guidance would not be a ‘safe harbour’ but would be a ‘sturdy breakwater’.

*'We are reluctant to introduce ever more intrusive regulation. To do so would add to our costs and to the regulatory costs of the industry, and could create defensive and costly markets, which might be smaller and less innovative. For this reason, we are focusing on delivering TCF based on principles. If the approach is successful, we would expect to see payback in both market-based success and less intrusive, and therefore less costly, regulation... Detailed rules are suitable for many areas of regulation, but in the field of fairness, which is flexible and dynamic, varying with particular circumstances, their impact can be limited. They tend to set a single standard and do not provide the flexibility that firms need to deliver fair treatment in a way that fits their target group of customers and their individual strategy. Principles do offer this flexibility.'*<sup>94</sup>

In 2004/05, the scope of the FSA increased. It took over responsibility for all mortgage regulation, including administration and mortgage advice. It also started to regulate general insurance activities, including car, home and pet insurance and more complicated forms of insurance such as critical illness and Payment Protection Insurance (PPI). PPI was widely mis-sold and accounted for between 30% and 40% of retail banking profits during the period it was sold. The FSA did not appreciate the full extent of profit made by a few high street retail banks as it lacked the capability to do market wide analysis. FSA officials had great hope that the industry would improve voluntarily, saying in 2005 that 'the simplest, quickest and most effective way forward' was that 'the industry could decide to improve its own standards and to move decisively towards putting in place the elements of a considerably more competitive market.'<sup>95</sup> To the Parliamentary Commission on Banking Standards, they justified their approach because:

*'the FSA board, and as communicated originally if I recall correctly even from Howard Davies as joint chair and chief executive of the FSA, took an approach based on the mantra of "We are not a price regulator". So the fact that the market was uncompetitive and as a result some consumers were paying much higher prices than they needed to pay was not necessarily something which the FSA would have picked up as being in itself mis-selling. There was nothing in the ICOB rule book which said you may not charge more than £X,000.'*<sup>96</sup>

The FSA conducted a number of mystery shopping investigations into PPI and issued a number of fines – although as consumer groups pointed out at the time, these were only a tiny proportion of the revenue gained from selling PPI. HFC were fined just 0.4% of their revenue gained from selling PPI and even after the FSA introduced a policy of increasing fines Alliance and Leicester were fined just 3% of their PPI revenue.<sup>97</sup> The banks resisted the FSA's actions and eventually sought a judicial review of the regulator's policy on how banks should deal with PPI complaints.

The increasing scope of the FSA increased the number of regulated firms from 10,500 initially to over 25,000. In 2008, the FSA also announced that it would be taking over responsibility for conduct regulation of retail banking deposit products – current accounts and savings accounts – from the voluntary Banking Code Standards Board.

## Light-touch regulation

In the years leading up to the 2008 financial crisis, the FSA found itself under pressure to deliver light touch

regulation. In 2005, Prime Minister Tony Blair, pointed out that the FSA was 'seen as hugely inhibiting of efficient business by perfectly respectable companies that have never defrauded anyone'.<sup>98</sup> A similar theme was emphasised by Ed Balls, who in 2006 pointed out that 'In the late 1990s, our decision to establish a single regulator for financial services, replacing the fragmented, overlapping and self-regulatory system we inherited with today's system of increasingly light-touch and risk-based regulation.'<sup>99</sup> Opposition politicians said that the FSA operated an 'Intrusive regulatory regime' and was 'increasingly a tool of the Treasury' which threatened to squeeze the life out of the City by over-regulating it. A memo prepared for the Conservative Shadow Treasury team in 2004 and released to The Telegraph said that the 'FSA's approach to retail financial services has been driven by fears of upsetting consumers and accused the FSA of aggressive attacks on sectors of the financial services industry'. The then Shadow Chancellor, Oliver Letwin MP, said that he was concerned by 'the intrusive regulatory regime' imposed by the City watchdog.<sup>100</sup>

Even the National Audit Office did not raise any significant concerns about the FSA's approach. In a report published prior to the financial crisis the NAO said that the FSA had 'developed and applied a rigorous risk-based methodology' which was 'highly regarded within the financial services industry in the UK and internationally and its risk-based approach is increasingly seen as a model to follow by other regulators.'<sup>101</sup>

Reflecting on the underlying regulatory philosophy of the time, Adair Turner described how:

*'there was a philosophy of regulation which emerged, not just in this country but in other countries, which was based upon too extreme a form of confidence in markets and confidence in the ideas that markets were self-correcting, which therefore believed that the fundamental role of the supervision of financial institutions, in particular banks, was to make sure that processes and procedures and systems were in place, while leaving it to the judgement of individual management to make fundamentally sensible decisions'.*

He added that there was 'a political philosophy where all the pressure on the FSA was not to say: "Are you looking more closely at these business models?" but to say: "Why are you being so heavy and intrusive? Can you not make your regulation a bit more light touch?"'<sup>102</sup> On the Prudential side 'There was a large amount of detailed investigation of relatively small things that weren't going to have a lot of impact on the overall riskiness of the Bank's balance sheet. There was a failure to look at the big risks that were being taken.'<sup>103</sup>

The report into the failure of HBOS<sup>104</sup> found that the FSA senior management adopted an approach to supervision which entailed placing heavy reliance on a firm's senior management and control functions. The FSA did not see its role as being to criticise a firm's business model in case it was perceived to be acting as a 'shadow director'. This approach gave rise to a supervisory framework with:

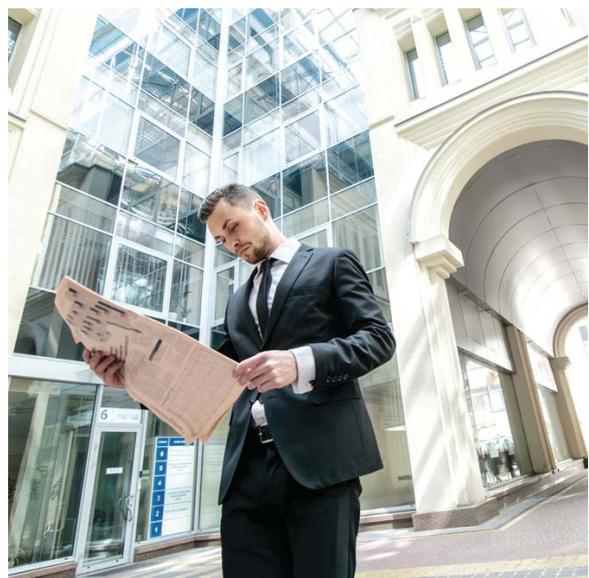
- inadequate resources devoted to the prudential regulation of large systemically important banks;
- inadequate focus on the core prudential risk areas of asset quality and liquidity in an apparently benign economic outlook;
- inadequate consideration of strategic and business model related risks, including the adequacy of capital buffers; and
- a risk-assessment process that was too reactive.

# What went wrong with the FSA – a failure of structure, culture and approach

The history of financial regulation in the UK operates in a cyclical fashion. Following a crisis, policymakers tend to increase regulation, give regulatory agencies new powers and reorganise their structure. However, the new powers are often undermined over time. This results in a new kinds of financial innovation, pressures for light-touch regulation from politicians and an overconfidence from regulators that they are now cleverer and more effective than in the past. This effectively lays the groundwork for a new crisis and another round of regulation.

Another consistent theme are constant promises by politicians and regulators that senior executives of firms will be held accountable for scandal and misconduct. Regulators and politicians have been promising this over 300 years – without much success. Indeed the situation has got worse.

The most crucial lessons is that it is not just what regulators do directly after a crisis that matters, but how they hold onto the lessons they learned and ensure that they continue to guide their actions – how regulators change their culture to embed this new approach.





## Regulatory Responses to 2008 Crisis

The financial crisis of 2008 was a significant challenge to the UK financial regulatory landscape. It stretched the regulators to their breaking point. It showed up some significant shortcomings which eventually led to a fundamental rethink of how the industry was regulated. The result was the foundation of the Prudential Regulation Authority and the FSA transforming itself into the Financial Conduct Authority. In this Appendix we trace these changes and map out the new regulatory structure and approaches which have emerged following the financial crisis.

## 2008: Review of Northern Rock and Supervisory Enhancement Programme

One of the first victims of the financial crisis of 2007-2008 was Northern Rock. The bank was forced to turn to the Bank of England for liquidity assistance during September 2007. This prompted the first run on a UK bank in 150 years. The bank was subsequently nationalised in February 2008.

Following this high profile failure, the FSA, the Bank of England and the Treasury announced the results of their review into the failure of the bank. The FSA published its response in March 2008 which said it believed that its 'overall regulatory philosophy as a risk-based, outcome-focused regulator is supported and reinforced by its analysis'. The review had several proposals for the improvement of the regulatory framework. It suggested that high-impact firms should be subject to ongoing supervision of core risk areas, with a specific focus on capital and liquidity. Supervisors should perform an annual review of the bank's business and strategic plans. Day-to-day supervision should also be more rigorous. The Supervisory Enhancement Programme (SEP) was to be a 'key component of the current three-year plan (2007 – 2010) which, in terms of internal change, has as its primary objective the creation of an effective management, operational and cultural framework to deliver more principles-based regulation.'<sup>105</sup>

The SEP was launched by the FSA in August 2009 and announced a number of changes, including:

- a) A significant increase in resources devoted to the supervision of high impact firms and, in particular, to complex banks;
- b) A shift in supervisory style to focus on key business outcomes and risks, and on the sustainability of business models and strategies;
- c) Emphasis on technical skills as well as probity in assessing approved persons;
- d) An increase in supervisory resources devoted to sectoral and firm comparator analysis, to better identify firms that are outliers in terms of risks and business strategies, and to identify emerging sector-wide trends that may create systemic risk; and
- e) A much more intensive analysis of information relating to key risks.

An important feature of the supervisory enhancement programme were issues of 'culture and people'. This included measures such as involvement of senior FSA officials in supervision; A focus on staff quality, retention and training; and increasing the number of supervisory staff by about 10%.

## 2009: Turner Review

The summer of 2008 brought a meltdown in global financial markets. This led to the widespread failure or near failure of systemically important financial institutions. Following emergency measures taken by regulators during 2008, there was a wider reflection on how regulators operated.

A key part of that in the UK was Adair Turner's review.<sup>106</sup> It included a wide range of recommendations to both banks and the regulatory landscape. An important part of that was continuing the implementation of the SEP. Central aspects of this which Turner identified as important were increasing resources devoted to supervising systematically important banks; focusing on business models and strategies rather than systems and processes; focusing on technical skills as well as probity; increased analysis of sectors and comparison between firms; investment in specialist prudential skills; increased product regulation; focus on remuneration policies; more information requirements and an intensification of balance sheet analysis.

Ultimately, what the review proposed was an approach to banking supervision that was more intrusive and systemic. This represented a departure from the 'light touch' approach to regulation which had dominated prior to the financial crisis.

## 2010: The announcement of a new regulatory landscape

A further step reforming the regulatory landscape was taken in June 2010 when the Government announced its proposed new regulatory arrangements.<sup>107</sup> A key part of this was the announcement of what would become known as the Financial Conduct Authority (FCA). This would be a 'strong consumer champion in pursuit of a single objective' and would have 'a dedicated focus on the importance of proper conduct'. The approach of this new authority was encapsulated in three goals:

- a) making the retail market work better for consumers;
- b) avoiding the crystallisation of conduct risks that exceed our risk tolerance; and
- c) delivering credible deterrence and prompt and effective redress for consumers.

These goals were to be achieved through three mechanisms:

- a) Seeking to improve the long-term efficiency and fairness of the market;
- b) Delivering intensive supervision of firms. The new supervisory approach will ensure firms treat their customers fairly and will equip the regulator to intervene earlier in the development of retail products. Interventions of this nature, which necessarily involve us making a judgement on potential detriment, will need to be based on sound business-model analysis and integrated firm-risk assessment;
- c) In the event that failure has occurred, the regulator will secure the appropriate level of redress and compensation (when justified), and achieve effective credible deterrence by taking tough action against firms and individuals who have transgressed.

In 2011, the White Paper confirmed the intention to transfer prudential supervision for banks, insurers and major investment firms to a subsidiary of The Bank of England, the Prudential Regulation Authority, and rename the FSA the Financial Conduct Authority.<sup>108</sup> In preparation for these changes it was announced that separate conduct and prudential business units would be created within the FSA.

# The Financial Services Act, 2012

The White paper of 2011 formed the basis of the Financial Services Act 2012. This established the current financial regulatory landscape. The Bank of England extended its remit to focus on issues of financial stability and established the Financial Stability Committee. The Financial Services Authority became the Financial Conduct Authority. Prudential issues were hived off from the FSA and became a subsidiary of the BoE – the Prudential Regulation Authority. Thus creating a twin peaks style regulatory model in the UK:

*'The financial crisis exposed the inherent weaknesses in the "tripartite" system of regulation in the UK. Perhaps the most significant failing is that no single institution had responsibility, authority or powers to oversee the financial system as a whole. Before the crisis, the Bank of England had nominal responsibility for financial stability but lacked the tools to put this into effect; the Treasury, meanwhile, had no clear responsibility for dealing with a crisis which put billions of pounds of public funds at risk. All responsibility for financial regulation was in the hands of a single, monolithic regulator, the Financial Services Authority, and there was clearly, in the run-up to the financial crisis, too much reliance on "tick-box" compliance.'*<sup>109</sup>

The Treasury Committee concluded 'Judgement-led regulation is welcome: the FSA has concentrated too much on ensuring narrow rule-based compliance, often leading to the collection of data of little value and to box ticking, and too little on making judgements about what will cause serious problems for consumers and the financial system.'<sup>110</sup>

## Bank of England (BoE)

The oversight of the UK financial system as a whole and responsibility for protecting and enhancing the stability of the system was given to the Bank of England.

The governance of the Bank was to work in the following ways. The Chancellor of the Exchequer was to direct the BoE where public funds were at risk and there was a serious threat to financial stability. A new Financial Policy Committee (FPC) of the Bank of England was created with powers to monitor and respond to financial stability risks. It could also issue recommendation and direction to the FCA or the PRA over matters of financial stability. The FPC became a sub-committee of the Court of Directors of the Bank of England, consisting of the Governor of the Bank, the Deputy Governor of the Bank, the Chief Executive of the FCA, a member appointed by the Governor of the Bank after consultation with the Chancellor of the Exchequer, four members appointed by the Chancellor of the Exchequer and a representative of the Treasury. The FPC meets at least quarterly and publishes its Financial Stability Report twice a year. The Report sets out its assessment of risks and weaknesses in the financial system based on a set of indicators and the measures it is taking to address them.

In order to co-ordinate with other regulators, both the FCA and the PRA must take appropriate steps to co-operate with the Bank of England in connection with, among other things, the Bank's pursuit of its financial stability objective.



In March 2013, the Financial Policy Committee (FPC) recommended that regular stress testing of the UK banking system should be developed to assess the system's capital adequacy. In a Discussion Paper published in October 2013, the Bank of England set out proposals for the main features of a framework for annual and concurrent stress-testing of the UK banking system. The inaugural stress test results were published on 16 December 2014 and explored vulnerabilities stemming from the UK household sector in particular, reflecting the Financial Policy Committee's assessment of the main domestic risks to financial stability at that time.<sup>111</sup>

## Prudential Regulation Authority (PRA)

The overall responsibility of the PRA is to supervise all firms that manage significant risks as part of their business. It provides prudential regulation of deposit takers (banks, building societies and credit unions), insurers and major investment firms. There are approximately 1,700 firms prudentially regulated by PRA. Prudential regulation aims to protect consumers and taxpayers from risks to the safety and soundness of individual firms and the stability of the financial system.

The PRA is led by the BoE Governor and a Deputy Governor. It has three supervision arms (insurance, international banks, UK deposit-takers), a supervisory risk specialists group and regulatory operations arm.

The Prudential Regulation Authority (PRA) has a statutory duty to maintain effective arrangements to consult practitioners and consider their representations. The Practitioner Panel considers the policies and practices of the PRA and provides input to the PRA Board in order to help it meet its statutory and operational objectives. The membership of the Panel is representative of PRA regulated firms. Members

have been nominated by trade associations, with the composition being broadly representative of how the PRA allocates its resources. Members are independent of the firm and trade association they are drawn from. The Panel meets approximately every six weeks and its members serve a three year term.

The PRA is led by its governing body, the Board. The Governor of the Bank is Chair of the PRA; the Bank's Deputy Governor for Prudential Regulation is the Chief Executive; the Deputy Governor for Financial Stability and the Chief Executive of the Financial Conduct Authority are members of the Board; and additional members are appointed by the Bank's Court of Directors, with the approval of HM Treasury. A majority of the Board must be made up of members who are not employed by the PRA or the Bank. Appointed members have renewable terms of three years.

The PRA and the FCA have a duty to co-ordinate the exercise of their functions. The Chief Executives of the regulators meet quarterly to review how well coordination is working. In certain circumstances, the PRA may, if it considers it necessary, direct the FCA to refrain from exercising its regulatory or insolvency powers in relation to PRA-authorized persons if the PRA is of the opinion that the exercise of the power in the manner proposed may threaten the stability of the UK financial system or result in the failure of a PRA-authorized person in a way that would adversely affect the UK financial system. This effectively means that the PRA can overrule the FCA in relation to large firms regulated by the PRA.

Some firms are subject to 'dual regulation', with their conduct regulated by the FCA and prudential matters regulated by the PRA. This requires coordination between the two regulators to ensure that there is no duplication or gaps in regulatory cover which firms are exploiting.

The PRA's general objective is to promote the safety and soundness of PRA authorized persons. It should seek to ensure that the business of PRA-authorized persons is carried on in a way which avoids any adverse effect on the stability of the UK financial system. It should seek to minimise the adverse effect that the failure of a PRA-authorized person could be expected to have on the stability of the UK financial system. Finally the PRA has an insurance objective of contributing to the securing of an appropriate degree of protection for those who are or may become policyholders.

The PRA has regard to a number of 'regulatory principles' set out in the Act. These cover: the need to minimise adverse effects on competition; efficiency; proportionality; the desirability of sustainable UK economic growth; senior management responsibility in firms; recognising differences in the nature and objectives of authorised persons; transparency; disclosure of information relating to persons on whom requirements are imposed by or under the Act; and the general principle of consumers taking responsibility for their decisions. The Act removed the need for the regulator to have regard to the international competitiveness of the UK as a location for financial services and the desirability of facilitating innovation.

The PRA's approach to using regulation and supervision has three characteristics:

- a) It is judgement based. The PRA uses judgement in determining whether financial firms are safe and sound, whether insurers provide appropriate protection for policyholders and whether firms continue to meet the Threshold Conditions.
- b) It is forward looking. The PRA assesses firms not just against current risks, but also against those that could plausibly arise in the future. Where the PRA judges it necessary to intervene, it generally aims to do so at an early stage.

- c) It is focused: the PRA focuses on those issues and those firms that pose the greatest risk to the stability of the UK financial system and policyholders. A stable financial system is one in which firms continue to provide critical financial services – a precondition for a healthy and successful economy.

The PRA does not seek to operate a 'zero-failure' regime. Rather, it seeks to ensure that a financial firm which fails does so in a way that avoids significant disruption to the supply of critical financial services.

## Financial Conduct Authority

The FCA protects consumers and supervises all firms to ensure that their business is conducted in a way that advances the interests of all users and participants. The FCA should provide conduct regulation and also the prudential regulation of non-PRA firms like smaller investment firms, exchanges and other financial services providers. According to the National Audit Office, before its expansion into consumer credit there were 26,000 firms which have their conduct regulated by FCA, and 23,000 firms prudentially regulated by FCA.

The FCA is tasked with maintaining arrangements for supervising authorised persons, monitoring compliance and taking enforcement action. It has a wide range of rule-making powers which go beyond the powers previously enjoyed by the FSA. It has a variety of executive and non-executive committees (including diversity). The organisation has nine divisions: (1) Supervision – retail and authorisations; (2) Supervision – investment, wholesale & specialists; (3) Strategy and competition; (4) Enforcement and market oversight; (5) Markets policy and international; (6) Risk and compliance oversight; (7) General Counsel; (8) Internal audit; and (9) Operations.

The FCA is required to coordinate with the PRA 'through day-to-day communication at working level, in addition to which there is regular more senior-level interaction. The PRA CEO and FCA CEO are members of the boards of the respective organisations'. The PRA has the power of veto where it considers that action FCA are taking may threaten financial stability or cause the failure of a PRA-authorised person in a way that would adversely affect financial stability.

The FCA's strategic objective is to ensure that the relevant markets function well. Its operational objectives are to:

- a) secure an appropriate degree of protection for consumers;
- b) protect and enhance the integrity of the UK financial system;
- c) promote effective competition in the interests of consumers in the markets for regulated financial services or services provided by a recognised investment exchange in carrying on exempt regulated activities.

As part of the Financial Services Act the FCA was given a number of new powers. These included the ability to ban financial products, publish details of misleading financial promotions, and let people know when we are proposing to take disciplinary action against a firm. The FCA also gained a recently activated power to establish individual firm or industry wide redress schemes.<sup>112</sup>

The FCA regularly assess firms' conduct, varying the intensity of assessment based on the nature and size

of the firm. It places firms in four different categories. The largest firms, with the most customers, face continuous assessment over rolling two-year periods. The assessments become progressively less intense for firms in the three other categories, with firms in category four having some form of assessment every four years. It carries out work on issues and products, undertaking fast, intensive campaigns on sectors of the market or products that are putting or may put consumers at risk. This work is driven by a sector risk assessment, which analyses the different areas of the market and the risks that may lie ahead. It also responds to events as they arise, by aiming to deal quickly and decisively with problems that are emerging or have happened, and securing customer redress or other remedial work where necessary.

In its document on the 'Journey to the FCA'<sup>113</sup>, the new regulator set out eight key success measures which it aimed to achieve in the first 3 years. These were that the regulator had:

- successfully intervened earlier to the benefit of consumers;
- dealt quickly and efficiently with 'crystallised risks';
- actively involved and engaged with our stakeholders and put consumers at the heart of what we do;
- addressed competition issues to the benefit of consumers;
- successfully influenced international policy;
- been able to deliver judgement-based, early intervention regulation;
- delivered business as usual; and
- encouraged positive cultural change in financial services firms

In April 2014 the FCA took over responsibility for consumer credit regulation from the Office of Fair Trading. This brought an additional 50,000 firms within the scope of the FCA's rules – many of these were small businesses. The FCA now regulates over 70,000 firms in total. The payday lending sector was identified as an early priority for action by the FCA. In 2013, Parliament had given the FCA a duty to introduce a price cap to secure an appropriate degree of protection from excessive charges for borrowers of payday lenders. It introduced a formal price cap on interest rates of 0.8% a day and capped default charges at £15 and the total cost of the loan at no more than the amount borrowed. Stricter rules were also introduced covering affordability assessments and restrictions on the ability of payday lenders to use Continuous Payment Authorities to take payments from consumers' bank accounts.<sup>114</sup> The FCA had also carried out thematic reviews into logbook loans, debt management and a market study of the credit card sector.

## Bank of England Act 2016

The Bank of England Act 2016 reformed the governance and accountability of the Bank of England. It ended the subsidiary status of the Prudential Regulation Authority – making it a full part of the BoE. The Act abolished the Bank's Oversight Committee. This committee was made up of the non-executive members of the Bank's board of directors, known as the Court. The Oversight Committee's functions were transferred to the Court. The Act allowed the National Audit Office to undertake value for money reviews of the Bank for the first time – although the subjects they will be allowed to examine are restricted.

Reforms were also made to the mechanisms intended to ensure that senior managers across the financial services industry can be held to account for failings that occur on their watch. The Senior Managers and Certification regimes were expanded to all firms. However, the 'reverse burden of proof' was removed and the onus is now back on the FCA and PRA to prove misconduct. The Government said that it would have been disproportionate to apply the reverse burden of proof to smaller organisations like building societies and credit unions.

The method of appointing the Chief Executive of the FCA was also changed to enable the Treasury Committee to hold a hearing with the individual before the appointment is confirmed. The Government made a promise 'in a future Bill, to make a change to the legislation governing appointments to the FCA CEO to make the appointee subject to a fixed, renewable 5-year term. This would not apply to Andrew Bailey...but would first apply to his successor.'<sup>115</sup>





# Comparing the culture of regulators in major financial centres

After exploring the UK case in depth, we illuminate the international context by giving a brief overview of the cultures of regulators in other leading global financial centres. We focus on regulators in ten of the eleven global leading financial centres.<sup>116</sup>

In the majority of these global financial centres there is a single regulatory authority, which in a few cases is integrated into the central bank (Ireland, Singapore). For the United States and Canada, which have multiple regulatory agencies for the financial sector, we focused on the regulatory agency with the broadest mandate (SEC and OSFI, respectively). For the United Kingdom we focused on both the FCA and PRA. This meant that we examined:

- Autoriteit Financiële Markten (AFM) – Netherlands
- Central Bank of Ireland – Ireland
- Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) – Germany
- Securities and Futures Commission (SFC) – Hong Kong
- Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA)
- U.S. Securities and Exchange Commission (SEC) – United States
- Autorité des Marchés Financiers (AMF) – France
- Monetary Authority of Singapore (MAS) – Singapore
- Office of the Superintendent of Financial Institutions (OSFI) – Canada
- Eidgenössische Finanzmarktaufsicht (FINMA) - Switzerland

Our review suggests that the culture of regulators varies substantially among the regulators of these financial centres. Indeed, as one top executive from a North American regulatory agency noted in a background interview, the culture of regulators is 'influenced by a number of things that are... country-specific', such as the size of the financial sector in a country or the type of interactions with the political system.

In order to flag up noticeable differences in organisational culture between the different regulatory agencies, we analyse the level of diversity in different regulatory agencies. In this report, having an organisational culture with high diversity means that regulatory agencies take into account many

different worldview and represents a broad set of stakeholders. By contrast, having an organizational culture with low diversity implies that regulatory agencies refer to a narrower set of worldviews and stakeholders. We use diversity to describe differences between the cultures of regulatory agencies without assuming that more (or less) diversity is necessarily better.

Specifically, we draw on two indicators for the levels of diversity. On the one hand we measure the diversity in topics by conducting a content analysis of the most recent annual reports of the regulatory agencies. On the other hand we analyse diversity in backgrounds by exploring where senior regulators worked before joining the regulatory agency. Our two measures suggest that substantive cultural differences do exist between leading regulatory agencies across the world. Our results also indicate that these differences in the cultures of regulators are correlated with different regulatory approaches.

## Diversity in topics

To analyse the diversity of topics that regulatory agencies engage with, we focus on the regulatory agencies' own annual reports. These reports offer a good overview of all the regulators' concerns over the course of the year and they are sufficiently similar in their aims and scopes to allow for a cross-national comparative approach. Analysing these reports helps us explore whether regulators decide to focus on a technocratic set of topics related to the day to day job of regulating the financial sector or whether they also cover a broader set of topics.

To analyse the topics we first compared the ten regulatory agencies' annual reports. We found five broad topics.

1. Topics of compliance include misconduct by financial firms and how the respective regulatory agency works towards preventing or punishing such misconduct.
2. Topics of stability refer to both the stability of individual institutions and the overall financial system.
3. Topics of accountability encompass measures of transparency and accountability aimed at ensuring the public is served in the best possible way.
4. Topics of consumer protection apply to considerations as to whether customers are treated fairly and find a level playing field.
5. Topics of structural policy refer to how regulatory agencies try to influence the structure of the financial sector, for example, to make it more competitive, internationally attractive or more sustainable.

For each of these topics we established a dictionary of commonly used terminology associated with the topic and measured the extent to which these occurred in the annual reports.<sup>117</sup> We analysed the most recent annual reports for each country and found that for each of the regulatory agencies the breakdown of topics covered was very similar between the years. We thus used averages from the two reports per country.

Overall, we find that 40% of relevant contents of reports refer to compliance, 31% to stability, 15% to consumer protection, 7% to structural policy, and 7% to accountability. Importantly, as shown in the Table at the end of this Appendix, the regulatory agencies vary greatly in how they prioritize the five topics.

Compliance is a major focus in the United States (80%) and Switzerland (58%), where the regulatory agencies give a very detailed account of all the violations of securities or banking laws that they encountered and of their respective enforcement activities. The stability topic is most prominent in Canada (65%) and Germany (60%); German regulators discuss both the capital requirements of banks and questions of risk management at greater length than any other regulatory agency. Consumer protection is a prominent topic in the regulatory authorities in the United Kingdom (36%) and the Netherlands (27%); both agencies report in great detail on their activities undertaken to protect and benefit consumers and their goal of creating a level playing field. Structural policy is a relatively big topic in Singapore’s regulatory agency (13%), which states its mission as promoting 'economic growth, and a sound and progressive financial centre,'<sup>118</sup> and French regulators (12%), who mention the sustainability of financial markets more often than other regulators. The topic of accountability received the widest coverage in the annual reports from Canada (16%) and Hong Kong (10%) respectively. The Canadian regulatory agency highlights how it collaborates closely with all stakeholders, while the Hong Kong regulatory agency makes a lot of references to how it serves the public interest.

Ensuring compliance is a largely technical activity that all regulatory agencies must – irrespective of their other priorities – engage in as their day to day commitment to support properly functioning markets. As its basic function and irrespective of whatever else it does, a regulatory agency must try and ensure that market participants do not manipulate markets and breach securities or banking laws. As expected, our analysis shows that regulatory agencies stick closer to the average for the compliance topic than for the other topics; that is, the variation in the volume of discussion of compliance is less than for the other topics.

By contrast, topics of stability, consumer protection, structural policy, and accountability constitute broader activities in the sense that now all regulatory agencies engage in them. For example, in their annual reports the US regulators hardly refer to accountability (1%) and stability (7%), Canadian regulators take little notice



of consumer protection (1%), and Swiss regulators pay little attention to structural policies (3%). Indeed, the Swiss regulatory agency explicitly mentions that it 'does not engage in structural policy.'<sup>119</sup> We thus see that the ten regulatory agencies are less consistent in how much attention they give to each of these broader activities.

Our proxy for the diversity of topics covered is the degree to which regulatory agencies focus on the basic activity of ensuring compliance. While all regulatory agencies cover the compliance topic, strong variations are noticeable in the degree to which they take into account broader topics (stability, consumer protection, structural policy, and accountability). In this sense, for example, the United States and Switzerland have a low diversity of topics. Their strong focus on compliance (80% in the US and 58% in Switzerland) may give them little room to take into account broader topics – or vice versa, their lack of discussion of less technocratic topics determines the narrow focus on compliance. By contrast, given a lower coverage of compliance topics in Canada (11%), Singapore (23%) and Germany (23%), these regulatory agencies have more leeway to explore broader topics.

## Diversity in backgrounds

The second way we analyse the level of diversity in the cultures of regulators is by researching the employment background of regulators. Do most regulators within a regulatory agency have a similar background or do they come from very different fields of work? Do most come from the banking or other financial sectors? To get an idea of executive personnel background we used the proprietary business intelligence database BoardEx to assess where top executives worked prior to joining the regulatory agency.

Our decision to look into regulators' backgrounds is grounded in a large array of academic and journalistic articles which, many motivated by the 2008 financial crisis, decided to consider the formal and informal ties between the financial sector and its regulators. This can sometimes be characterised as the 'revolving door' between the financial sector and regulators. These articles suggest that the ideas and actions of regulators can be influenced through shared identities and shared networks with financial sector employees. We focus specifically on the top executives because previous studies have shown that top executives have a very high influence on an organisation's culture and policy outcomes.

We began our research with an explorative study into a selection of senior regulators per agency, randomised where possible. Where possible we drew our data from the agency's websites and beyond that from business intelligence site BoardEx. We classified the prior work experience of top executives at a regulatory into the five categories:

1. finance (banking, asset management, etc.);
2. insurance, accounting;
3. academia;
- 4). law, and;
- 5). other (government services, journalism, consulting, etc.).

As top executives sometimes worked in different industries we counted connections rather than people. That is, if a top executive spent a decade working as a journalist after working a decade as an investment banker, this would be counted as two separate connections.

Our findings, as illustrated in the Table at the end of the Appendix, show that there is a difference in the level of diversity of pools from which the employees we looked at were drawn: especially the Dutch, US and British top level regulators seem to stem from a variety of backgrounds including not only finance but also business, law, academia and others, such as journalism. In comparison, the Swiss and Irish regulatory agencies display less variety.

We then looked more closely at specific sectors represented within the regulators' previous employments pool. In this paragraph we wish to highlight several noticeable results. We found, for example, that the Dutch agency scored most diverse across the board, with no sector noticeable overshadowing another, and a higher level of former business people and academics than most. The regulatory authorities from the United Kingdom, Singapore, France, and Ireland all had comparatively high numbers of former bankers, higher than any other. But no regulatory agency was, in our data, so very much dominated by bankers as Swiss regulatory agency – together, former bankers (48%) and others former employees from the financial sector make up 76% of overall connections. The US regulators also showed a high degree of diversity in backgrounds – there, notably, we see the largest number of lawyers or other legal professionals employed. The German regulators turned up a larger diversity score than many, however, an unusual (in comparison) high concentration of former insurance employees – many of which even seemed to have employed by the same insurance firm, Allianz. This is interesting given that in our content analysis of the BaFin annual report, special attention is paid to risk management topics. Singapore and Hong Kong both had an average number of former bankers as employees and average amounts of diversity – notably, both employ former senior politicians.

Reviewing our findings given scholarly focus about informal ties between the financial sector and its regulators we looked at a simple indication of reliance on the financial sector for an employee pool, and received further results. For example, despite the British regulators being one of the most diverse and the Swiss regulator one of the least diverse in their overall employee pool in our study, both employ a clear majority of financial sector veterans compared to for example Amsterdam, which has a much more evenly mixed pool in our database and cannot be said to rely as heavily on one field. Our measure 'percentage of top executive connections to financial sector' divides the number of connections to the financial sector through the overall number of connections.

## Relating the culture of regulators to regulatory approaches

Figure A4.1 illustrates the ten regulatory agencies and shows large differences in the percentage of connections to the financial sector among their executives (vertical axis) and the percentage of compliance topics covered in their annual reports (horizontal axis). We see these differences as a significant marker that the cultures of regulators vary substantially among the leading financial centres.

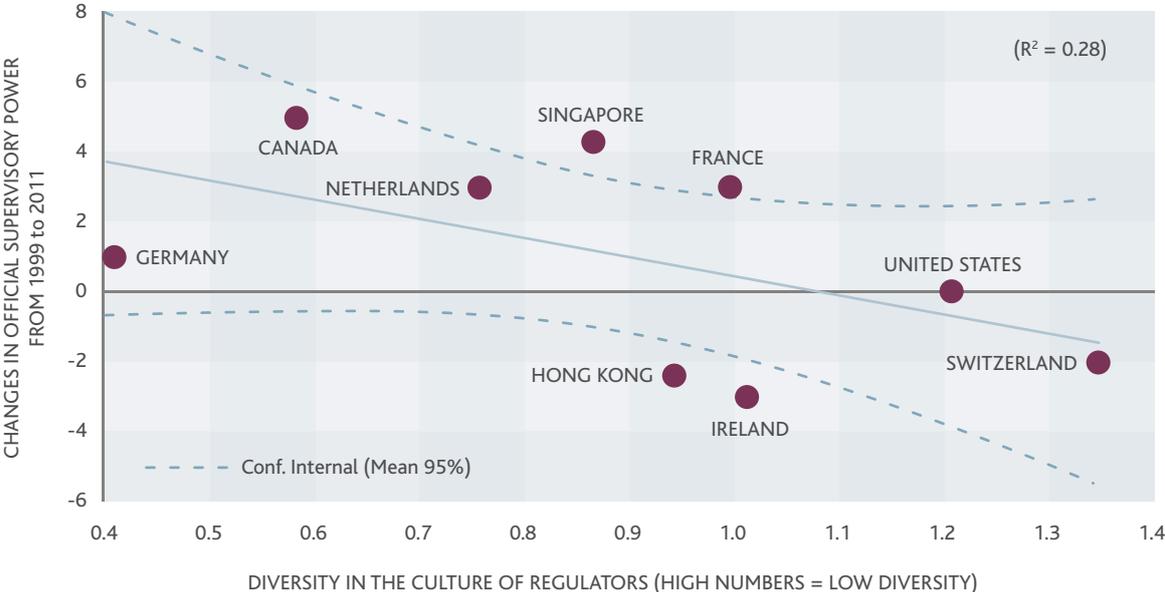
Figure A4.1 - Differences in the culture of regulators in leading financial centres



In this section we show that these differences matter for how countries regulate financial markets. When looking at policy outcomes, different countries take different approaches to financial regulation, as documented in surveys from the World Bank. Based on these surveys, the World Bank economists James R. Barth, Gerard Caprio, and Ross Levine compare financial regulation in different countries.<sup>120</sup> Particularly interesting for our context is their index for the strength of official supervisory power. The authors measure supervisory power based on survey questions such as 'Can the supervisory authority force a bank to change its internal organizational structure?' or 'Are off-balance sheet items disclosed to supervisors?' These authors then analyse how the strength of official regulatory power has changed over time by comparing the years 1999 and 2011 (before and after the 2008 financial crisis). They find substantive differences in the trajectories of different countries. While the strength of official regulatory power has increased substantially in Canada (+5) and Singapore (+4.3), it became weaker in Ireland (-3) and Hong Kong (-2.4).

These changes in the strength of official regulatory power are correlated with the culture of regulators as measured by the sum of our two axes. Figure A4.2 shows that countries such as Switzerland or Ireland, whose regulatory agencies have a low degree of organisational diversity (that is, given our data they are governed by many people with a predominantly financial only background and a strong focus on compliance before and above other topics), have weakened the official regulatory power. By contrast, countries whose regulatory agencies have a high degree of organisational diversity, such as Germany or Canada, have strengthened their official regulatory power. The correlation is particularly strong for the European and the North American countries.<sup>121</sup>

Figure A4.2 - Correlation between the culture of regulators and changes in supervisory power



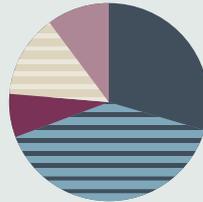
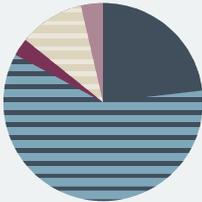
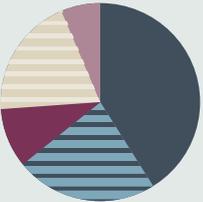
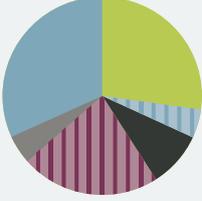
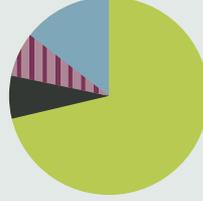
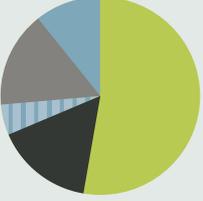
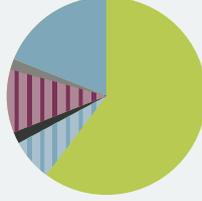
This correlation indicates that organisational culture could be a factor in determining regulatory activity. Our expert interviews confirm this notion: for example, one top executive from a European regulatory agency explained that a change of culture was seen as necessary to implement a more assertive approach to financial regulation after the 2008 financial crisis. Prior to this change, 'the policy of financial regulation ... tended to be influenced by a philosophy of encouraging industry.' Another senior regulator from North America notes that they encourage diversity in backgrounds because 'we found that it is beneficial to have a range of experiences and perspectives around the executive table.' In addition to expertise from the financial sector, their regulatory agency actively aims to bring in 'people who have deep knowledge and understanding of public policy objectives and how public policy works.'

In line with the last statement, academic research also suggests that higher diversity within organisations lowers the risks of one-sided information and evidence influencing policymakers and targeted regulators.

In comparison to their international peers, the FCA and PRA have a strong focus on compliance though not overly so, as less than half of their reports are devoted to this topic. What stands out is an extended focus on consumer protection, which in turn leaves only little space for accountability and structural policies. The FCA and PRA seemingly draws their top management from a wide range of diverse sectors, however with a strong reliance on the financial sector which twice as many of their top regulators have links to than to any other sector.

Our current results suggest that the culture of regulators matters for financial regulation. We find that when there is a homogenous culture, financial regulators only tend to focus on a narrow range of topics and issues. However when regulators nurture a more diverse culture they consider a wider range of issues. This broader perspective can act as a guard against group think.

Table: Overview over the culture of regulators in ten leading financial centres

Financial Centre: <b>Amsterdam, Netherlands</b>	Financial Centre: <b>Dublin, Ireland</b>	Financial Centre: <b>Frankfurt, Germany</b>	Financial Centre: <b>Hong Kong, China</b>	Financial Centre: <b>London, England</b>
<p>Main Regulatory Agency:</p> <p>AFM (Autoriteit Financiële Markten)</p>	<p>Main Regulatory Agency:</p> <p>Central Bank of Ireland</p>	<p>Main Regulatory Agency:</p> <p>BaFin (Bundesanstalt für Finanzdienstleistungsaufsicht)</p>	<p>Main Regulatory Agency:</p> <p>SFC (Securities and Futures Commission)</p>	<p>Main Regulatory Agency:</p> <p>FCA (Financial Conduct Authority) &amp; PRA (Prudential Regulation Authority)</p>
<p>Topics in Annual Reports:</p> 	<p>Topics in Annual Reports:</p> 	<p>Topics in Annual Reports:</p> 	<p>Topics in Annual Reports:</p> 	<p>Topics in Annual Reports:</p> 
<p>Background of Top Executives:</p>  <p>based on 22 connections</p>	<p>Background of Top Executives:</p>  <p>based on 14 connections</p>	<p>Background of Top Executives:</p>  <p>based on 17 connections</p>	<p>Background of Top Executives:</p>  <p>based on 19 connections</p>	<p>Background of Top Executives:</p>  <p>based on 58 connections</p>
<p>Official Supervisory Power:</p> <p><b>Greater power</b> (+3) in 2011 than in 1999</p>	<p>Official Supervisory Power:</p> <p><b>Less power</b> (-3) in 2011 than in 1999</p>	<p>Official Supervisory Power:</p> <p><b>Greater power</b> (+1) in 2011 than in 1999</p>	<p>Official Supervisory Power:</p> <p><b>Less power</b> (-2.4) in 2011 than in 1999</p>	<p>Official Supervisory Power:</p> <p><b>No data available</b></p>

Topics in Annual Reports: ● Compliance ● Stability ● Accountability ● Consumer Protection ● Structural Policy

Official Supervisory Power (see Barth et al. 2013, p40)

Financial Centre: <b>New York, United States</b>	Financial Centre: <b>Paris, France</b>	Financial Centre: <b>Singapore, Singapore</b>	Financial Centre: <b>Toronto, Canada</b>	Financial Centre: <b>Zurich, Switzerland</b>
<b>Main Regulatory Agency:</b>  SEC (U.S. Securities & Exchange Commission)	<b>Main Regulatory Agency:</b>  AMF (Autorité des Marchés Financiers)	<b>Main Regulatory Agency:</b>  MAS (Monetary Authority of Singapore)	<b>Main Regulatory Agency:</b>  OSFI (Office of the Superintendent of Financial Institutions)	<b>Main Regulatory Agency:</b>  FINMA (Financial Market Supervisory Authority)
<b>Topics in Annual Reports:</b>  	<b>Topics in Annual Reports:</b>  	<b>Topics in Annual Reports:</b>  	<b>Topics in Annual Reports:</b>  	<b>Topics in Annual Reports:</b>  
<b>Background of Top Executives:</b>  <p>based on 27 connections</p>	<b>Background of Top Executives:</b>  <p>based on 27 connections</p>	<b>Background of Top Executives:</b>  <p>based on 22 connections</p>	<b>Background of Top Executives:</b>  <p>based on 15 connections</p>	<b>Background of Top Executives:</b>  <p>based on 25 connections</p>
<b>Official Supervisory Power:</b>  <b>Equal power</b> (±0) in 2011 than in 1999	<b>Official Supervisory Power:</b>  <b>Greater power</b> (+3) in 2011 than in 1999	<b>Official Supervisory Power:</b>  <b>Greater power</b> (+4.3) in 2011 than in 1999	<b>Official Supervisory Power:</b>  <b>Greater power</b> (+5) in 2011 than in 1999	<b>Official Supervisory Power:</b>  <b>Less power</b> (-2) in 2011 than in 1999

Background of Top Executives: ● Finance ● Insurance ● Accounting ● Academia ● Law ● Other



## Cognitive Biases in Financial Regulators

Financial regulators around the world have started to reflect on the role which cognitive biases play in financial markets. In particular regulators have increasingly sought to use the field of behavioural economics - examining how cognitive biases can lead consumers to make predictable mistakes when choosing and using financial products. However, there has been little reflection on the role which cognitive biases play within financial regulators or how these biases affect the way the regulator's staff and executives take decisions.

Cognitive biases are the mental short-cuts which we use to make decisions. They are particularly prevalent when we are making decisions under pressure or under conditions of uncertainty. Cognitive biases are useful because they help us to make decisions quickly. But they are dangerous because they can often lead us to incorrect conclusions.

# Cognitive Biases

There have been nearly four decades of research on cognitive biases. Psychologists have documented over fifty different cognitive biases. For about a decade, economists have recognised that agents in financial markets often fall prey to cognitive biases. A handful of studies have identified the cognitive biases which are particularly pertinent to financial regulators. Some of the biases which are most pertinent to financial regulators include:<sup>122</sup>

**Bounded search.** Financial Regulators often only look for a limited range of problems. These are typically shaped by the kinds of problems in which they are skilled and used to finding in organisations. Once they have found something which resembles one of the limited range of problems which they are looking for, then they often select from a very limited range of remedies. This helps to speed up analysis processes, but it often leads to misdiagnosis and poor prescriptions of remedy. Problems are only diagnosed when they are familiar – but many other problems are missed. Regulators only rely on a limited range of remedies – which could mean other potentially useful regulatory measures are overlooked. For instance, in the lead up to the 2008 financial crisis, UK regulators normally set rules around the sales process for products and the disclosure of information to consumers. This meant they overlooked problems with the products themselves and never considered banning products like PPI. Regulators may also fall back on disclosure remedies – perhaps based on simplistic statements like ‘Sunlight is the best disinfectant’. Reviewing disclosure materials may also be used as a strategy by regulators so that they can say that they are ‘doing something’ about a particular market. For example, regulators have responded to complaints about poor outcomes in the annuity market by reviewing the letters sent to consumers when they retire – without much overall impact on the market.

**Bounded Rationality.** Financial Regulators are often inundated with information. They receive a constant stream of data from the firms which they regulate. In addition they receive large amounts of market intelligence. The problem is that they are often unable to effectively process all this information. As a result, they only look at particular pieces of information. This can effectively create tunnel vision where they only see information which fits, or obviously does not fit, a pre-existing template. It can mean that information which is not neatly picked up by this template is missed. For instance to judge whether a firm has appropriate conduct, a financial regulator might tick off a series of boxes. Once these boxes are ticked, no other information is considered. This can mean regulators neglect huge swathes of data which they actually already have. It can also mean that regulators find it hard to be proactive in their policy-making – ignoring a potential problem until the evidence of it is overwhelming – by which time it is too late to do anything about it.

**Availability, Hindsight and Fundamental Attribution Biases.** These are three ways which regulators might sort the deluge of information which they are faced with. Availability bias means that they tend to unduly focus on the recent or easily available. For instance, if there have been some recent bad news stories about a particular firm or sector, their attention is likely to be drawn in their direction (although the problems in the market might be elsewhere). They also suffer from hindsight bias – placing too much emphasis on past events which actually occurred (rather than near misses for instance). This can mean that regulatory agencies can effectively be regulating for the last crisis. Fundamental attribution bias means we tend to over-estimate the role which innate factors play in driving wrong-doers and under-estimate situation factors. This tends to mean that once a financial regulator identifies a problem, it tends to focus on a few suspect firms and ignore broader structural factors which might have caused these problems.

**Framing effects.** Framing is way which a particular piece of information is presented. Often we judge information based on the broader messages around it. Perhaps the most well-known framing effect is when something is presented as a loss, then we are more likely to focus on it than if it was framed as a gain. Regulators are well known for being particularly prone to this risk aversion, so they will often go out of their way to minimise losses and lose sight of potential gains. Similarly, if information is framed in a way which resonates with existing values in an organisation then people are more likely to attend to it than if it is presented in terms of values which are alien to the organisation. This can lead regulators to pay more attention to information which is framed in terms of dominant values or ideas in the regulator.

**Overconfidence.** This is the tendency to assume that one is better than one actually is. We typically overestimate our abilities and the impact which we have on the world around us. In regulatory organisations, this means they are often overconfident about the efficaciousness of their actions, the accuracy of their prescriptions and their organisational abilities. For instance, many financial regulators in the world tend to think they are among the best financial regulators in the world. This can mean they are less open to learning from others. Similarly, history shows that regulators often display significant confidence in their regulatory system just prior to significant financial crises. When setting the new capital requirements for banks the Bank of England reduced the amount of capital it thought banks should hold as it believed that the PRA was a more effective supervisor than the FSA. The PRA also exhibits overconfidence in believing that it now has the tools and ability to close down large banks which run into difficulty without causing financial panic.

**Confirmation Bias.** This is the tendency to only seek out information which confirms our existing point of view. Confirmation bias is particularly pronounced when information is ambiguous and an actor is forced to justify their decisions publicly. Financial regulators are often driven by confirmation bias when they focus on information which confirms their over-arching assumptions of regulatory positions. Once regulations are on the books, regulators may feel the need to justify their worth instead of critically evaluating their effects. This can mean they entirely miss information which does not confirm their position. For example, the assumption that increased information will help consumers make the right decisions will lead them to focus on information provision strategies rather than other issues. This search for evidence which confirms the regulators position is exacerbated by the constant need for financial regulators to justify themselves publicly. It often means financial regulators are forced to be overly confident about their position in public, but then start to believe this overly confident position. Confirmation bias can also occur when regulators only assess the costs and the benefits of their proposed regulation after they have already decided what to do.

**Group think.** This occurs when individuals become committed to a group and subsequently they align their thinking to fit with the prevailing consensus in the group. When information is presented which does not fit with the dominant values of the group, it is overlooked. This can often mean that even when individuals perceive a problem or disagree with the group, they are willing to overlook it in favour of group consensus. In financial regulators this means that once a regulator has taken a particular policy position, members will tend to disregard sharing information or opinions which disconfirm this position. This has the advantage of affirming a strong group coherence and corporate culture. But it also comes with the risk that issues which don't neatly fit with group consensus are overlooked. The risk of group think can be exacerbated if decisions within financial regulators are made by committees.

**Social influences:** Emotions and norms in social interactions are important: regulators may allow themselves to be persuaded or trust the person from the bank they are supervising because he or she comes across as

'likeable' and therefore trustworthy. As regulators have greater social and workplace interaction with those from larger institutions they may fail to challenge the decisions made. Regulators may also fail to challenge or question social groups to which they think they belong. For example, some people may identify as bankers who are just temporarily working in the regulator. Research in the Dutch financial regulators found that supervisors with previous tenure in the financial sector are more likely to socially identify with the financial sector and that social identification with the financial sector negatively affects supervisors' task performance.<sup>123</sup>

**Salience and vividness:** All of us struggle to give sufficient attention to complex problems. This can lead to people falling back on simplistic soundbites about regulation – 'principles-based', 'outcomes focussed', 'risk-based'. It can also lead to regulators and politicians putting forward arguments like 'regulation shouldn't constrain innovation' or 'consider the unintended consequences' to argue against proposed regulation.

## De-Biasing

Each of these cognitive biases are deeply rooted in human cognition. Financial regulators are settings which are ideal for cognitive biases to flourish: They are overburdened with information, much of the information they receive is ambiguous and open to multiple interpretations, they are constantly under pressure to justify their decisions publicly, in some cases there is a deep rooted culture and individuals stay with the organisation for a long period of time, and often organisational members feel embattled by external players. All these factors can lead to financial regulators to double down on their judgements – even when this might not be justified by the evidence.

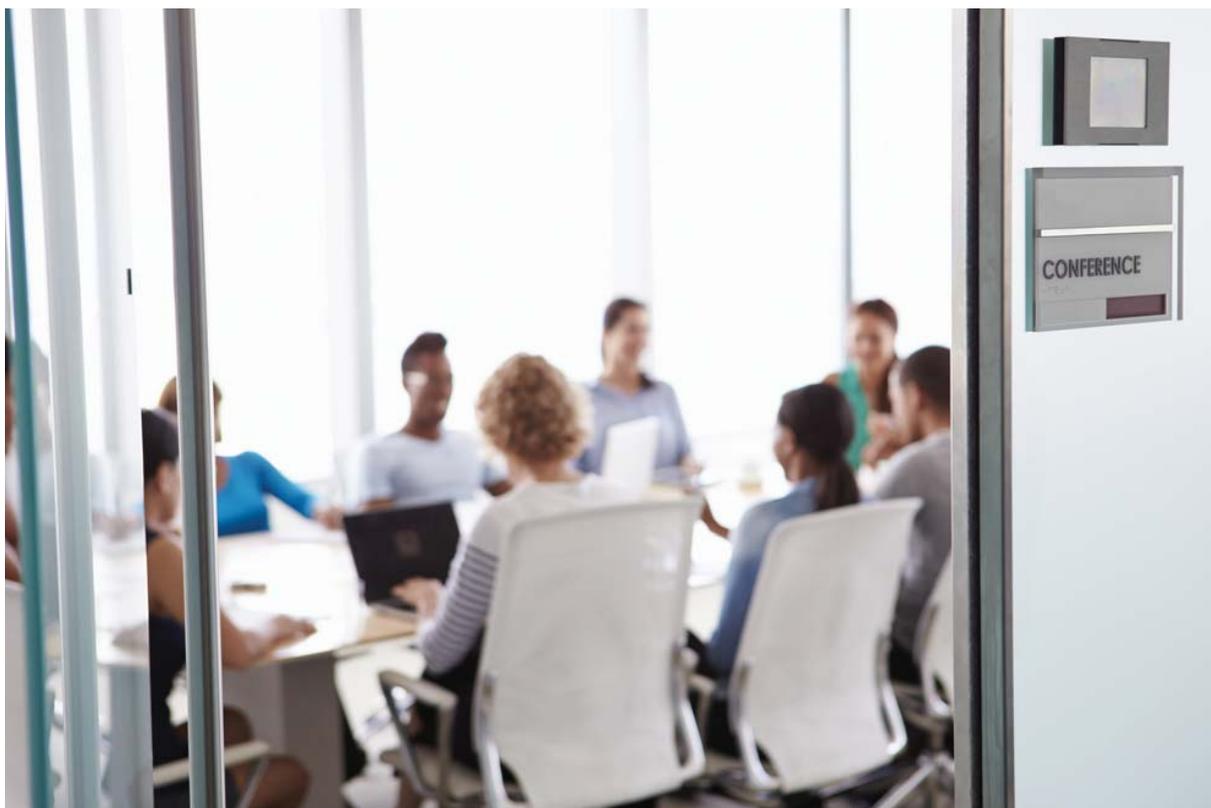
Some measures have been suggested for decreasing cognitive biases, including the follow:<sup>124</sup>

**Education.** By providing additional information which might have been missed which will help to make a more rounded choice. For instance, regulators might be given information from experts on current thinking about their own and others areas of expertise.

**Awareness of cognitive biases.** Simply informing regulatory officials of different cognitive biases is likely to make them less likely to fall prey to them. For instance, if they are aware of loss aversion they can correct their perceptions when making decisions. However, there is also a danger that awareness about cognitive biases can be quickly forgotten, particularly when an individual is faced with a challenging situation.

**Increase Diversity.** Teams which are more diverse tend to have a wider range of perspectives and question and challenge others perspectives. This means that they are more likely to come to higher quality decisions if managed correctly. This could include increasing the diversity of backgrounds of those in the teams. The key to unleashing the potential of diverse teams is to ensure that they get their different perspectives and assumptions on the table early in a group process. If they hold off and pretend they are all similar, it is likely underlying differences will derail the group process later on.

**Wisdom of the crowd.** Averaging estimates from the predictions of wide group of people often yields better predictions than a single or a few experts. This can be done in a number of ways. Regulators could poll external audiences on important questions to get a sense of what the average answer might be. Regulators could also use internal polling to generate predictions. Finally, teams or even individuals can harness the



wisdom of internal crowds by articulating a range of estimates and then averaging. This process often helps to break up disciplinary tunnel vision of experts.

**Internal questioning and evaluation.** This can be done by appointing devils advocates whose task is to question a group. This might slow decision making down, but it generally leads to higher quality decisions. Regulators could also ensure all projects have post-mortems and pre-mortems. Post-mortems are the well-known process of reflecting on lessons learned from a projects and feeding these forward. Pre-mortems are a less well known process whereby actors ask what could go wrong. They do this by doing a short exercise whereby at the start of a project they collectively imagine what factors might contribute to the projects failure and how they might be ameliorated. All three of these processes can help to temper the optimism of individuals, making them less likely to be over-confident about their decisions.

**Generating alternatives.** This involves at some point of the analysis process seeking to generate as many alternative interpretations or courses of action as possible. Although many will be useless, they will often help to widen people's thinking. Research has shown that the more alternatives which are generated in a decision making process, the better the eventual decision tends to be.

**Modelling.** This involves removing expert judgement (and expert bias) from the picture and relying on computer models to predict outcomes. This can be done by collecting historical data on a range of input and output variables, weighting each variable appropriately and then examining predictions. This can help regulators to break up the over-reliance on recent performance on one of two variables. It can help regulators realise that often they have been looking at the wrong thing when making judgements. However it is also crucial to be aware that computer models also have inbuilt biases which can also skew predictions.

**Incentives.** It is possible to overcome cognitive biases in some cases by adjusting incentive structures. For instance, if we remove immediate incentives for quick decisions and increase incentives for longer term thinking then it is likely snap decisions most likely to be plagued by bias will be reduced. Similarly, if incentives to agree with group consensus are removed then it is likely that more divergent opinions will be voiced.

**Accountability.** Increased accountability can increase the costs of making the wrong decision. By increasing accountability, regulators are more likely to be incentivised to carefully consider their decisions and possible biases. For instance if regulators are aware that they will be accountable for their decisions through processes of public review, they are more likely to thoroughly consider the thinking process rather than come to a decision hastily. However, in the realm of financial regulation accountability could, in the first instance be to Government officials and politicians who may also be subject to behavioural biases – such as believing that the economic and regulatory system that they have designed is superior to other countries.<sup>125</sup>

**Choice Architecture.** By changing the way information is presented to a person, it is possible to increase the quality of their decisions. One way to do this is by relying on defaults, where users are automatically given a better choice and have to actively opt out of it. This harnesses the power of inertia and automatic behaviour. Regulators could harness defaults by considering the kinds of information and the order it is presented in to supervisors or enforcement officials. A second way is to introduce nudges which encourage reflection. These are subtle behavioural prompts which force people to stop and reflect on their decisions for a moment. For instance, when making a decision regulators might be prompted to think about risks, the dynamics of implement or perhaps alternative scenarios. Another alternative is planned interruptions, where regulators are asked to step back and think about their course of action for a moment. Finally, situations can be presented to regulators where they have to make an active choice rather than just letting events passively run their course.

**Future Oriented Decisions.** Regulators can also design choice situations so people make more reasoned decisions in the future. Often people's considerations about the future are more rational than those in the present. This can be harnessed through choice in advance, whereby actors have to make a choice about a course of action in advance rather than waiting until the last possible time. Building on top of this individuals can then be required to pre-commit to actions. This means they have not only made a choice, but there is also a potential cost if they back out of that course of action. Another way to do this is through 'temptation bundling' where a pleasurable activities (incentives) are bundled together with activities which might be experienced as costly or unpleasurable in the short term but beneficial in the longer term. For instance regulators could bundle together aspects of their jobs which they enjoy with more painful aspects which have longer term payoffs.

**Building social identity as a regulator:** This could be done by implementing policies designed to reduce social identification with the financial sector particularly for those with extensive prior experience of the sector. Stimulating a strong professional identity of being a supervisor, through measures such as introductory programmes and follow-up courses, setting up a professional group of financial supervisors or stimulating membership of professional groups and professional qualifications, are likely to curb regulatory capture

**Presentation of Information.** The final way which regulators can de-bias decisions internally is by considering the way which information is presented to officials. For the results of consultations, information

could be presented giving equal weight to views of consumers/consumer groups and industry – even if the overwhelming majority of response come from the industry. To get around feelings of being overwhelmed, regulators could be presented with a few simple but crucial metrics about the firms they supervise. These may help to draw attention to important factors rather than inducing confusion. Regulators also need to carefully consider which information is presented – for instance is it only for this year or is it over a longer period of time. By expanding the scale, people can come to more reasoned decisions. Regulators also need to consider how this information is framed. For instance, if it is framed as a loss then others are more likely to act on it than if it is framed as a gain. Using graphic or pictorial representations of complex data can also help individuals to process it and incorporate it into their decision making. Finally, providing social norms can also prompt desirable behaviour. For instance if regulators are provided with information about averages on certain metrics and where a supervised firm sits in relationship to these averages, it may prompt a closer look at under-performing firms.



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