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Single or twin? The UK financial regulatory landscape after the financial crisis of 2007-2009.

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Abstract:

Purpose – The author aims to analyse the weaknesses of the Financial Services Authority (FSA) and the Bank of England during the financial crisis of 2007-2009. She aims to discover whether the coalition government's proposal to a twin-peaks model is a better alternative to the single regulator. The focus of this paper is on micro-prudential regulatory failures in the UK. A comparison will be made with the twin-peaks regulatory model in Australia where there were no bank failures.

Design/methodology/approach – The paper is based upon an analysis of recent papers and reports. Descriptive statistics are used to provide an insight into the financial ratios of the top banks in the UK and Australia. A comparative legal analysis between the UK and Australia is used to reflect the common law system used by both.

Findings – The structure of the UK regulator was only a minor contributory factor to the financial crisis. The main regulatory and supervisory failures are due to organisational and management problems. There needs to be better information flow, co-ordination, co-operation, engagement with banks and stricter internal controls. The new UK regulator also needs to be prepared for the changes on the European dimension, following the de Larosiere report.

Practical implications – This paper will have policy implications for practitioners and policy makers on national, European and international dimensions. Changes in the European regulatory structure will see an emphasis on vertical regulatory co-operation.

Originality/value – By first reviewing the weaknesses of the FSA in light of Northern Rock and HBOS and then comparing the FSA with the Australian regulatory model, this paper provides a new insight into financial regulation.

Keywords: Financial regulation, twin-peaks model, Financial Services Authority, single regulator, financial crisis, financial stability

Article type: Research paper

1. Introduction

The UK was ranked first on the overall Financial Development Index of the World Economic Forum 2009. However, it was ranked 37th in financial stability. The World Economic Forum has recommended improvements in regulation and oversight, including official supervisory power in the UK (World Economic Forum, 2009). The regulatory and supervisory framework of the UK financial regulator is thus of importance. Regulation refers to the rules which govern the behaviour of banks. Supervision focuses on the oversight by the regulator to ensure that banks adhere to the rules (Barth et al, 2006). Regulation can be divided into macro and micro-prudential regulation. Macro-prudential regulation concerns the stability of the entire financial system. Micro-prudential regulation focuses on the regulation of individual organisations. In the United Kingdom, the Bank of England is responsible for macro-prudential regulation from 1997 till present. Responsibility for micro-prudential regulation is primarily the responsibility of the Financial Services Authority (FSA) but individual organisations are also responsible for implementing the rules. In practice, regulation and supervision are often intertwined. Therefore, although this author tries to separate the two in the paper, it is necessary to assess them together at times. Whilst this paper will include a discussion on the Bank of England as the macro-prudential regulator, the focus is on the FSA's role as the micro-prudential regulator and supervisor.

Ineffective micro-prudential regulation could lead to problems such as poor risk management, regulation and supervision; high leverage; insufficient liquidity and capital within banks. Liquidity, leverage and capital are all connected. Adrian and Shin (2010) submit that 'aggregate liquidity is intimately tied to how hard the financial intermediaries search for borrowers'. In the sub-prime crisis, banks lent money to customers who had no realistic chance of repaying it. This is because banks had surplus capital which is costly to retain. During a boom, asset prices increase and balance sheets are stronger. Banks have to find ways to use their capital to increase leverage. According to Brunnermeier (2009), there were two "liquidity spirals" during the financial crisis. When asset prices drop, financial institutions' capital erodes and, at the same time, lending standards and margins tighten. Both effects cause fire-sales, pushing down prices and tightening funding even further' (Brunnermeier, 2009). These liquidity spirals lead to banks protecting their funds so inter-bank lending decreases. Bank runs then follow and capital levels deplete. Northern Rock is a prime example.

Much has been written on the demise of Northern Rock (Yorulmazer, 2009; Bruni & Llewellyn, 2009; Milne & Wood, 2008). There is a gap in the literature in that little has been written on HBOS. The author will review the roles of the Bank of England and the FSA in section 2. Section 3 consists of an analysis of HBOS. In section 4, the author will analyse whether the twin-peaks model will address problems such as regulatory co-ordination; information sharing and conflict of interests. The paper will draw comparison from the Australian experience. Section 5 is a discussion on what changes the FSA has made since the financial crisis. Section 6 discusses the results and makes recommendations. Section 7 concludes the paper.

2. Literature Review

The UK labour government adopted the tripartite system in 1997. Under the tripartite system, the FSA supervises financial institutions; the Treasury is responsible for legislation and the Bank of England for financial stability. The justification for a tripartite system was that the boundaries between financial institutions have blurred. Banking, insurance and securities overlap. Complex group structures, innovative financial products and processes such as securitisation have led to the phenomenon of ‘functional despecialisation’ (Taylor, 2009) Traditional banks adopted the ‘originate-to-distribute’ model in the late 1980s and boundaries between banks, insurance and securities companies have blurred. Banks and the shadow banking organisations have thus become increasingly interwoven. A single regulator would be better positioned to monitor modern financial institutions.

Northern Rock is an example of ‘functional despecialisation’ and the tripartite system has revealed weaknesses of the FSA and the relationship between the FSA and the Bank of England. Northern Rock was formerly a building society. In 1997, it became a bank when it was listed on the London Stock Exchange. However, Northern Rock had a very unusual business model. It combined a traditional reliance on illiquid long-term mortgage assets with a reliance on innovative sources such as securitisation and the wholesale market (Milne & Wood, 2009). Mortgages constituted 77% of Northern Rock’s assets. At the end of 2006, Northern Rock issued asset-backed securities through its ‘Granite’ securitisation vehicles and obtained 40% of funding (Milne & Wood, 2009). Wholesale funding constituted 68% of Northern Rock’s liabilities whilst deposits only made up 27% of its liabilities (Goldsmith-Pinkham & Yorulmazer, 2009).

Poor financial ratios at Northern Rock between 2003-2009 should have alerted some the FSA. Table 1 below reveals the liquidity, debt, capital and profitability ratios amongst the biggest UK and Australian banks. The ratios are a five year average between the years of 2004-2009. Northern Rock had the highest loans to deposits ratio; second highest debt to equity ratio, a poor capital ratio and negative profitability ratios.

Name of bank	**Country**	**Cash ratio 5 year average (%)**	**Debt-to-Equity ratio 5 year average (%)**	**Loans to deposits ratio 5 year average (%)**	**Tier 1 Capital ratio 5 year average (%)**	**Return on equity ratio 5 year average (%)**	**Return on assets 5 year average (%)**
Royal Bank of Scotland	United Kingdom	16.68	21.10	115.22	8	9.26	-0.30
HSBC	United Kingdom	44.67	16.07	96.64	8.8	7.26	0.66
Barclays	United Kingdom	55.72	25.90	93.28	8.8	20.96	0.35

Lloyds TSB	United Kingdom	27.14	29.85	113.86	8.5	19.15	0.60
HBOS	United Kingdom	5.10	38.98	179.24	7.2	0.23	0.04
Standard Chartered	United Kingdom	17.27	10.79	89.80	9.2	14.51	0.92
Northern Rock	United Kingdom	8.14	76.54	242.86	-18.7	-75.46	-0.60
Bradford & Bingley	United Kingdom	6.07	85.52	132.56	8.3	25.12	0.14
Alliance & Leicester	United Kingdom	6.93	38.42	145.90	7.6	14.25	0.94
Nationwide Building Society	United Kingdom	4.52	32.02	115.72	10.0	7.42	0.22
Westpac Banking Corporation	Australia	22.68	20.02	135.00	7.3	19.57	0.95
Commonwealth Bank of Australia	Australia	24.12	16.80	134.22	7.68	17.64	0.98
ANZ	Australia	26.49	15.09	124.34	7.74	14.54	0.89
National Australia Bank	Australia	43.92	17.24	116.92	7.65	12.26	0.75

Table 1: Liquidity, Debt, Capital and Profitability Ratios of UK and Australian Banks
Source: Annual reports and author's calculations

The poor financial ratios are a reflection of weak corporate governance by Northern Rock and regulation/supervision by the FSA. They ultimately led to a liquidity problem and bank run at Northern Rock. The House of Commons Treasury Committee (2008) was critical of the FSA in both its roles as regulator and supervisor.

As a supervisor, the FSA failed to allocate sufficient resources to monitor Northern Rock where its business model was unusual. It failed to supervise Northern Rock properly when it adopted an ambitious expansion policy and when its share price fell sharply in late 2007. With regards to human resources, the FSA should not have approved the Chairman and CEO of Northern Rock, as they were not qualified bankers. They have significant experience but running a big bank without suitable qualifications is a hazard.

The FSA labelled Northern Rock as a 'high impact bank, under close and continuous supervision' (House of Commons Treasury Committee, 2008). However, the FSA only carried out an ARROW risk (Advanced Risk Responsive Operating Framework) assessment every three years. It acknowledged that the interval between assessments was 'inadequate' (House of Commons Treasury Committee, 2008). The FSA defended its position by stating that it maintained a close relationship with Northern Rock through 'very regular dialogues...on a full range of supervisory issues' (House of Commons Treasury Committee, 2008).

Although the main problem at Northern Rock was one of liquidity, the FSA weakened Northern Rock's capital position by approving the Basel II waiver. This meant that Northern Rock was able to increase its dividends and so its balance sheet was weakened. Before the FSA approved the Basel II waiver, FSA reviewed Northern Rock's stress-testing scenarios. The FSA was unhappy with the scenarios but it failed to relay that message to the directors of Northern Rock. It also failed to rectify the scenarios.

The House of Commons Treasury Committee concluded that the tripartite system (Bank of England, FSA and HM Treasury) failed to work well. Northern Rock had to ask the Bank of England for emergency relief, since it was the lender of last resort. By separating the roles of banking supervision/regulation from lender of last resort, decision-making was slow and inefficient. The Bank of England was criticised for taking a reactive approach in the Northern Rock episode (Buiter, 2008 in House of Commons Treasury Committee, 2008). In comparison to the Federal Reserve and the European Central Bank (ECB), the Bank of England was slow to act, arguing that injecting liquidity would create a risk of moral hazard (House of Commons Treasury Committee). Several banks asked the Bank of England for additional liquidity at no penalty rate in August 2007. The Bank of England was reluctant to provide more liquidity at different maturity dates against weaker collateral (House of Commons, 2008). It refused to engage in liquidity transformation. It was in mid September 2007 when the Bank of England created a Liquidity Lending Facility for Northern Rock. Wood (2008, cited in House of Commons Treasury Committee, 2008) supports the Bank of England's approach. In his view, the ECB and the Federal Reserve were wrong to adopt such a proactive policy and that it would lead to problems in the future. The House of Commons Treasury Committee concluded that whilst it was hard to tell whether the liquidity facility could have saved Northern Rock, the Bank of England should have broadened its range of collateral earlier in the crisis. The Bank of England did not take any contingency measures when the ECB and the Federal Reserve did. Overall, its conclusion was that rather than restructuring the tripartite system, the House of Commons Treasury Committee wanted to keep it but with clearer leadership and stronger powers.

The FSA published its own review on Northern Rock in March 2008. According to the report, the extent of the problems at Northern Rock was a surprise to them. In the FSA's view, Northern Rock was 'at the extreme end of the spectrum' that they observed. In terms of supervision, there was a lack of resources and experience in monitoring Northern Rock. Northern Rock was supervised by the insurance group of the Major Retail Groups Division until 2006. Three Heads of Departments were responsible for Northern Rock, although one of them was in practice for only three months (FSA, 2008, p.2). There was however, continuity in the manager and lead associate for supervising Northern Rock. The lead associate's account clearly revealed that staff at the FSA were stretched during a busy period of takeovers, bids and demutualisation. The FSA pursued a policy of 'fewer and better staff' (FSA, 2008, p.7). It reduced its staff by about 20 between 2004 - 2008. As a result, Northern Rock was poorly supervised. The specific supervisory failures include: failure to update the internal risk database; no Risk Mitigation Plan for Northern Rock; insufficient engagement with the bank and long gaps between Close and Continuous meetings.

Regulatory failures at Northern Rock are revealed in capital, liquidity and stress testing. When Northern Rock breached its capital position in March 2007, FSA took action to rectify the problem. However, there was no written record of a meeting between the FSA and Northern Rock representatives on the reasons of the breach. Lack of rigour and internal controls appear to have affected the FSA's performance. These problems are manifested in regulating liquidity as well. When the FSA made an ARROW visit to Northern Rock in February 2006, they did not carry out a stress test even though liquidity was included was on the agenda. Although there were no material weaknesses in the liquidity management framework, the FSA admitted that more frequent checks on the data are required. The FSA has drawn up 39 lessons it had learnt from the Northern Rock episode. The seven high level recommendations include improvements to the rigour of day-to-day supervision; senior management to increase engagement with high impact firms; increase its focus on prudential supervision (including liquidity and stress testing); improve resources; improve the quality and resources of its financial and sectoral analysis and senior managers should increase their oversight of supervision. No dates have been set for these recommendations but the FSA will implement them as part of a wider programme.

3. HBOS

HBOS was formed in 2001 when Halifax Plc and the Governor and Company of the Bank of Scotland merged. At the end of 2006, HBOS was the fourth largest UK bank in terms of assets (Milne & Wood, 2009). According to the 2007 HBOS Annual Report, HBOS held 20% of the mortgage market and 16% of the savings market (HBOS, 2007, p.8). Like many other banks, HBOS experienced rapid growth between 2003-2008. Debt increased from £112 billion in 2003 to £231 billion in 2007 and total assets increased from £408 billion in 2003 to £667 billion in 2007 (HBOS, 2007, p.14). HBOS experienced liquidity problems during the financial crisis. The Chief Executive of HBOS, Andy Hornby, admitted that 'it is clear with the benefit of hindsight that, over many years of reliance on wholesale funding, that left us in a vulnerable position.' (House of Commons Treasury Committee, 2007). The poor liquidity ratios revealed in Table 1 further corroborates the liquidity problem at HBOS. HBOS's share price fell sharply in March 2008 after rumours of short-selling in the bank. FSA carried out a market rumours investigation. In August 2008, it confirmed that it did not find any evidence that rumours were spread as part of a concerted attempt by individuals to profit by manipulating the HBOS share price. It is commendable that the FSA took action as soon as possible.

Despite the false allegation of short-selling, HBOS's share price fell a further 18% on 15th September 2008 when Lehman Brothers filed for bankruptcy. Despite reassurance from HBOS that it has a strong capital base by Shane O'Riordain, the Group Communications Director of HBOS, the shareholders were not convinced and share price fell a further 22%. Emergency talks took place on 17th September 2008 between HBOS and Lloyds TSB. The

Labour government was keen to avoid another Northern Rock scenario. It therefore relied on the argument of public interest, waived European competition law rules and approved the deal between Lloyds TSB and HBOS. On 18th September 2008, Lloyds TSB and HBOS announced that the latter would be takeover by Lloyds for £12.2 billion.

HBOS failed due to a combination of weak corporate governance and poor regulation. The FSA first raised its concerns about HBOS back in 2003. They carried out a full ARROW risk of HBOS's Retail, Corporate, Treasury and Group Functions. Due to limited resources at the FSA, they could only carry out a limited risk review in each division. They would then produce a 'Risk Mitigation Plan' for HBOS to follow (Moore, 2009). Moore explained that if the FSA suspects that there are key risks, they would ask HBOS or an external expert to carry out additional work and assess the risks. If the bank carries out the additional work, this will normally be assigned to one of the two Group Risk functions that existed at the bank, either Group Regulatory Risk or Group Financial and Operational Risk (Moore, 2009). In November 2003, the FSA's report was published. The report contains evidence that '…the risk posed by the HBOS Group to the FSA's four regulatory objectives is higher than it was perceived'. In relation to HBOS's retail side at the Halifax, 'there has been evidence that development of the control function in Retail Division has not kept pace with the increasingly sales driven operation…' and 'there is a risk that the balance of experience amongst senior management could lead to a culture which is overly sales focused and gives inadequate priority to risk issues.' (Moore, 2009)

The FSA's ARROW visit in 2003 identified the key risks. Moore believed that 'the operational staff at the FSA had done a good job on the ARROW visit they had conducted and that they almost certainly had identified the key risks at the bank at that stage in its development' (Moore, 20010). He added that 'staff [at the FSA] at that level would not be accountable for what happened at HBOS'. Nevertheless, in Moore's interview with the author held in July 2010, Moore was critical of the FSA. He stated that the FSA failed to supervise properly because it adopted a 'light-touch' approach to regulation and supervision. It failed in their statutory duties, which were to maintain market confidence, protect retail customers, fight financial crime and ensure proper consumer education. According to Moore (2010), the main failure of the FSA was that it failed to act upon the red flags.

The FSA has not commissioned a report on HBOS. Instead, it issued a statement on 11th February 2009 in response to Moore's allegations regarding HBOS's regulatory failures in December 2004. According to the statement, the FSA conducted a full ARROW risk assessment in late 2002. It subsequently asked PricewaterhouseCoopers to carry out a 'skilled persons report' in accordance with section 166 of the Financial Services and Markets Act 2000. The 'skilled persons report' revealed that HBOS needs to improve its risk management system. The FSA conducted another risk assessment of the entire HBOS Group, formally recording the assessment in December 2004. HBOS has made improvements in addressing the risks highlighted in the previous assessment. Nevertheless, the FSA was of the view that HBOS's group risk functions needed to 'enhance their ability to influence the business' (FSA, 2009). It continued to monitor HBOS and wrote to HBOS again on 29th June 2006, expressing their concerns about control issues and the bank's growth strategy. With regards to Moore's allegation that the new group risk director was not 'fit and proper' for the job, HBOS commissioned KPMG to investigate. The FSA only appointed the new director when KPMG's results showed that there was no evidence to suggest that the new group risk director was not 'fit and proper'. The FSA also had a separate meeting with Moore to discuss this issue. The FSA concluded its statement by emphasising that it had already raised concerns about HBOS's regulatory framework prior to Moore's allegations.

4. Changes on the horizon since the financial crisis

The previous sections highlighted the weaknesses and failures of the tripartite system, in particular the FSA. Hector Sants, Chief Executive of the FSA, admitted that the FSA failed in both roles as regulator and supervisor. In his speech at the Annual Lubbock Lecture in Management Studies, Sants announced the changes that the FSA has made since the financial crisis (Sants, 2010). He stressed that the FSA is an 'influencer' of prudential roles, not a decision-maker. The majority of decision-making is set at the European and international level, so he appealed that the FSA should be judged according to the effectiveness of its supervision rather than the quality of the prudential regulations. On capital and liquidity, the FSA has put in place a liquidity and 'interim' capital regime. This is consistent with the Basel Committee. On supervision, the FSA has shifted from a reactive 'principles-based' approach to a proactive 'outcomes-based' approach. The new approach is more intensive. It focuses on stress-testing and on the future. Hence the forward-looking approach to capital for banks recently adopted by the FSA improved the capital positions of banks because a challenging stress test was used. The FSA will conduct annual stress test with all major financial institutions. This would involve reviews of their portfolios, projections and strategies. According to Sants, the structure of the regulator was not 'a major contributory factor to the crisis' (Sants, 2010). He acknowledged that there were deficiencies in the tripartite system but the status quo should be kept. The FSA has the 'right people making the right decisions, and the right policies and rules in place to support that process' (Sants, 2010). Further, the UK regulator's role in regulation will be restricted in the future. Future regulatory policy and rules will be decided on the European level under the new European regulatory framework. This is an interesting point which deserves closer examination.

On 1 January 2011, the new European financial supervisory framework came into force. The key features of the reform are the creation of a European Systemic Risk Board ('ESRB') and three European Supervisory Authorities ('ESAs') (the European Banking Authority ('EBA'), the European Securities and Markets Authority ('ESMA') and the European Insurance and Occupational Pensions Authority ('EIOPA')). The ESRB is in charge of macro-prudential supervision. The ESRB will work with national authorities such as the Financial Policy Committee in the UK, which is the proposed new institution responsible for macro-prudential regulation. The three ESAs will work under the European System of Financial Supervision ('ESFS') together with the existing national supervisory authorities. They are responsible for micro-prudential supervision. The Prudential Regulatory Authority ('PRA') will represent the UK in the new ESAs for banking and insurance, whilst the Consumer Protection and Markets Authority ('CPMA') will represent the UK in the ESMA.

The ESAs have wide-ranging powers which include: drafting specific rules and guidelines for national authorities and financial institutions in the form of technical standards, guidelines and recommendations; and monitor how rules are being enforced by national regulators (they will in some circumstances be able to give binding instructions to national regulators and financial institutions); take action in emergencies, including the banning of certain products; mediate and settle disputes between national supervisors.

Member states can decline to comply with a recommendation or guideline but technical standards will be binding as an EU regulation or decision. The regulatory paradigm will shift from the national to European level. The theoretical paradigm will become increasingly focused on vertical rather than horizontal regulatory co-operation. Horizontal regulatory co-operation between the tripartite authorities failed under the UK single regulator. The first step that the UK government should take is to rectify the problems mentioned earlier in the paper before considering the overall structure of the regulator. Structure alone will not solve everything. The second step is to consider whether the Australian twin-peaks model is better for the UK. The European regulatory changes call for more vertical regulatory co-operation between the national and European regulatory bodies. With the Bank of England and PRA reporting to the ESRB and ESFS, the twin-peaks model should in theory, be more aligned to the European level.

5. Twin-peaks model

George Osborne, the current Chancellor of the Exchequer, announced on 16th June 2010 that the coalition government would reform the UK financial regulatory landscape. He recommended a shift from the single regulator to a 'twin-peaks' model on grounds that the tripartite system "failed spectacularly" in ensuring financial stability (BBC, 2010). The HM Treasury document of 2010: 'A new approach to financial regulation: judgement, focus and stability' explained that "The tripartite system of financial regulation failed to ensure financial stability - in particular by failing to identify the risk posed by the rapid and unsustainable increase in debt in the economy. This resulted in considerable economic costs in lost output and in a substantial deterioration in public finances. The regulatory system cannot be restructured without primary legislation." (HM Treasury, 2010) The HM Treasury consultation document has raised a number of macro-prudential failures of the FSA. These include: -

1. Failure to identify the problems that were building up in the financial system;
2. Failure to take steps to mitigate the above problems; and
3. Failure to deal adequately with the crisis when it did break, especially during the first part of the crisis in the summer of 2007.

According to the HM Treasury consultation document 2010, the macro-prudential failures arose due to an 'underlap' of macro-prudential regulation. Whilst the rationale of the tripartite system is an 'overlap' of financial products and thus the phenomenon of 'functional despecialisation' (Taylor, 2009), in reality, the structure of the tripartite system was weak. The FSA was given too much work and responsibility in relation to financial regulation. The Bank of England had nominal responsibility with little power or resources. The Treasury was ill prepared and equipped for crises. In addition to this dismal picture, the UK lacked a single institution which could deal with financial regulation as a whole. With an 'overlap' of financial products and an 'underlap' of macro-prudential regulation, it is little wonder that the balance tipped in favour of financial innovation than stability. Together with the micro-prudential failures mentioned earlier in this paper, the HM Treasury consultation document 2010 states that micro-prudential regulation failed because of an over-reliance on a 'tick-box' compliance regime. There was a lack of thorough understanding of business models and risk analysis.

Against this backdrop, it is therefore necessary to consider whether the UK government should adopt the twin-peaks model. According to the coalition government's reform proposal, the Financial Policy Committee (FPC) will be responsible for macro-prudential regulation. It will be a subsidiary of the Bank of England. The FPC will comprise of bank executives and will have macro-prudential tools to regulate financial institutions. Micro-prudential regulation will be the responsibility of the new Prudential Regulation Authority (PRA) will deal with prudential and financial regulation. The PRA will also be a subsidiary of the Bank of England. The Consumer Protection and Markets Authority (CPMA) will promote confidence in the financial markets. The main advantage of this proposal is that both macro and micro-prudential regulation is brought under one institution—the Bank of England. There is a consultation period on this reform proposal until end of 2011, with a view of legislating the proposal in 2012. Proponents of the twin-peaks model argued that the twin-peaks model is better in times of crises. Having the lender of last resort and information gathered as the banking regulator would accelerate the decision-making process (Taylor, 2009) Drawing on the Australian experience will assist policy makers in deciding which structure would work best for the UK.

Australia adopted the twin-peaks model in 1998 following the Wallis Inquiry of 1996. The Wallis Inquiry was not a consequence of a scandal or crisis. Therefore, it can be argued that the Wallis Inquiry was free from political pressure when reviewing the regulatory structure (Cooper, 2006). Australia withstood the financial crisis of 2007-2009 better than the UK. No Australian bank failed. There were no mergers or acquisitions of weaker banks. The G30 Report on the Structure of Financial Supervision of 2008 revealed that both Australia and the Netherlands are amongst the best and most effectively regulated regimes in the world (G30, 2008). It would appear that the twin-peaks model works very well in Australia. However, the failure of HIH Insurance Limited in 2001 illustrates the failures and weaknesses of the Australian Prudential Regulatory Authority (APRA). HIH Insurance Limited was the second largest general insurance company in Australia. It collapsed with a debt in the region of \$3.6 - \$5.3 billion (Clark, 2007). The Royal Commission into HIH's collapse found that the APRA was reluctant to intervene in HIH when the latter was in trouble. APRA was formed on 1st July 1998 and it was inexperienced in understanding the extent of HIH's problems (Clark, 2007).

Justice Owen of the Royal Commission held that APRA 'did not cause or contribute to the collapse of HIH' (HIH, 2003a). However, APRA 'missed many warning signs, was slow to act, and made misjudgements about some vital matters.' (HIH, 2003a) Justice Owen said that APRA was weak in a number of areas. First, APRA did not have staff with the relevant skills or experience. Resources were inadequate. Secondly, there was a lack of information flow upwards to APRA's board and managers. They were not properly informed on lack of resources or on HIH's financial performance. Thirdly, like the FSA, APRA adopted a 'laissez-faire' approach to regulation. Although HIH's collapse was ultimately due to corporate governance failures, this episode reveals that APRA could have dealt with the problem better.

To rectify the weaknesses, Justice Owen made three recommendations. First, he recommended that the CEO and executive commissioners should replace the non-executive board of APRA. This should improve the information flow to the senior level. Secondly, he called for a restructuring of the APRA. Reorganisation is required to improve accountability. He also urged the creation of a specialist team of staff to supervise insurers. Finally, the APRA should be more firm and aggressive in its style of prudential regulation and supervision.

APRA learnt from the experience and in October 2002, it introduced new risk assessment and supervisory response tools known as the Probability and Impact Rating System (PAIRS) and the Supervisory Oversight and Response System (SOARS). The HIH Insurance scenario illustrates that the APRA experienced teething problems in both regulation and supervision. Nevertheless, it has learnt from its experience and made the necessary changes. With no bank failure during the financial crisis of 2007-2009, it seems that the problems of regulatory co-ordination, information sharing and conflict of interests have not troubled the APRA again. The UK government could learn from this episode. If the twin-peaks model is adopted, the PRA needs to be well-organised and has skilled experts. There must be clear co-ordination and co-operation both within the regulatory bodies and outside. Transparency and accountability should be encouraged with good information flow upwards and downwards. It is encouraging to note that the coalition government will give the Treasury power to set out in secondary legislation the exact macro-prudential tools available to the Financial Policy Committee (HM Treasury, 2010). These tools are vital to detect risks and improve regulation and supervision.

6. Findings and recommendations

This paper has extended the literature on financial regulation by examining the macro and micro-prudential failures of the tripartite authorities, especially the FSA during the financial crisis of 2007-2009. It is important to emphasise that Northern Rock and HBOS failed due to a combination of corporate governance and regulatory failures. However, this paper focuses on the latter, especially the micro-prudential failures and weaknesses of the FSA. The purpose of this approach is to identify whether the weaknesses and failures are due to the structure of the FSA or other reasons. This will have important implications for the future of UK financial regulation. The author has found that there are weaknesses with the tripartite authorities.

The Northern Rock demise has revealed that FSA failed in both regulating and supervising the bank. By waiving Basel II regulations on capital, Northern Rock was able to pay dividends to its shareholders and further weakening its capital position. The FSA was aware of the capital situation before it waived the Basel II requirements. However, it failed to channel that information to the board of Northern Rock and did not rectify the problem. It did not regulate the bank's liquidity well. As a supervisor, it failed to monitor the bank properly when it was evident that Northern Rock's business model was unusual. It carried out ARROW risk assessments every three years when it identified the bank as 'a high impact bank, under close and continuous supervision' (House of Commons, 2008). The admission by the FSA that Northern Rock was 'at the extreme end of the spectrum' is a clear indication that there were serious failures in both regulation and supervision by the FSA.

Compared to Northern Rock, the regulation and supervision at HBOS were marginally better based on the evidence available. Moore's evidence revealed that the operational staff at the FSA performed well (Moore, 2009). They had identified the major risks at HBOS. It was at the senior management level where problems emerged. The main failure was that the FSA failed to notice the warning signals. Arguably, the FSA could and should have done more about the problems at HBOS.

The studies into the role of FSA in both Northern Rock and HBOS revealed similar weaknesses and failures. A thorough post-mortem analysis was conducted into Northern Rock by both the House of Commons Treasury Committee and the FSA, so more information is available in the public domain on this bank. Nonetheless, from the information available, it is apparent that common supervisory weaknesses include: insufficient engagement with the banks; lax information recording systems; failure at the senior management level and poor monitoring of the banks. Lack of resources and poor information flow were noticeable in both banks. Regulatory failures include capital, liquidity and stress testing. The FSA has been perceived as focusing more on capital and solvency rather than liquidity (Buiter, 2008 cited in House of Commons, 2008). Both Northern Rock and HBOS ultimately needed government assistance because of liquidity problems. Therefore, the primary regulatory failure is in liquidity and stress testing.

The demise of HIH Insurance Limited exposed initial problems of the twin peaks model in Australia. The APRA lacked skilled staff and resources. It failed to notice warning signals and was slow to act. There was poor communication and information flow. The APRA adopted a 'light-touch' approach to regulation. These weaknesses are similar to the FSA. Therefore, the structural difference between the two regulators is not a key factor to their regulatory and supervisory failures. Rather, the regulators failed in both countries due to organisational and management weaknesses, especially at the senior management level. Should the UK maintain the single regulator and make improvements or move to the twin-peaks model? The status quo could be retained if the necessary recommendations are acted upon. Further, the Banking Act 2009 gives the tripartite authorities power to deal with failing banks in an emergency. It has thus given the FSA powers to stabilise banks but this is curative rather than preventative. Proximity between the Bank of England and the FSA will assist with preventative measures. When macro and micro-prudential regulation/supervision is vested within one umbrella organisation, the PRA can in theory, react quicker to market volatility and provide liquidity where necessary. Macro and micro-prudential regulation/supervision are closely connected: 'Macro-prudential supervision cannot be meaningful unless it can somehow impact on supervision at the micro-level; whilst micro-prudential supervision cannot effectively safeguard financial stability without adequately taking account of macro-level developments' (de Larosiere, 2009). The proposed changes to the European regulatory framework suggest a regulatory emphasis on vertical co-operation. Lord Turner and de Larosiere both stressed the importance of good regulation on a global scale in their reports (Turner, 2009; de Larosiere, 2009). After all, global banks are 'global in life but national in death' (King, 2009, cited in Turner, 2009)

Effective global financial regulation starts at home. Until the UK government has fully learnt and implemented the changes, the question of the structure of the regulator is of secondary importance. The structure only provides the outer shell of an organisation. It requires the necessary tools, equipment, resources, information and co-ordination to perform properly. It is evident from this paper that it is exactly these concerns that the UK regulator should address. The Australian experience further supports the fact that the twin-peaks model does not resolve all the problems.

7. Conclusion

"New structures do not guarantee better regulation...Any country that thinks that tinkering with the structure of agencies will, by itself, fix past shortcomings is doomed to relive its past crises" (Carmichael, 2003)

Moving to the twin-peaks model *per se* will not solve the failures and weaknesses of the FSA and the Bank of England. Rather, the UK government must learn from the experiences of Northern Rock, HBOS and Australia. It needs to rectify the problems revealed in the financial crisis. In view of the current economic climate and with a deficit of £1000.4 billion as at March 2010 (ONS, 2010), it is questionable whether the UK government should spend money on restructuring the UK regulator. Whilst the proximity of the Bank of England and the PRA and FPC under the twin-peaks model is attractive, this is of no benefit if the bodies differ in their opinions on rescuing banks. We do not know whether the FSA supported additional liquidity in the Northern Rock episode since they relied on the principle of confidentiality (House of Commons Treasury Committee, 2008). The delay in granting liquidity support to Northern Rock seems to suggest that there were differences in opinion between the tripartite authorities. Hence, the UK government should appeal for more co-ordination and co-operation within the regulatory bodies, be it single or twin.

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