THE FINANCIAL SERVICES AUTHORITY: A MODEL OF IMPROVED ACCOUNTABILITY?

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ABSTRACT

Prior to the adoption of the FSA (Financial Services Authority) model, supervision of UK banks was carried out by the Bank of England. Although the Bank of England's informal involvement in bank supervision dates back to the mid nineteenth century, it was only in 1979 that it acquired formal powers to grant or refuse authorization to carry out banking business in the UK. Events such as the Secondary Banking Crisis of 1973-74 and the Banking Coordination Directive of 1977 resulted in legislative changes in the form of the Banking Act 1979. Bank failures through the following years then resulted in changes to the legislative framework. This article looks into the claim that the FSA model has improved in terms of accountability in comparison to its predecessor, the Bank of England. It considers the impact the FSA has made on the financial services sector and on certain legislation since its introduction. Through a comparison with the Bank of England, previous and present legislation, reports and other sources, an assessment is made as to whether the FSA provides more accountability. Evidence provided here supports the conclusion that the FSA is both equipped with better accountability mechanisms and executes its functions in a more accountable way than its predecessor.

INTRODUCTION

This article investigates whether improvements have been made by the Bank of England's successor, the Financial Services Authority – hereinafter referred to as the FSA. Part of the problems encountered by the Bank of England's regime was related to the Financial Services Act 1986. Through an analysis of the legislation operating during the Bank of England and FSA's regimes, an assessment will be made as to whether accountability has been improved within the financial services sector. An analysis of both regulators' approaches to supervision and their regulatory framework is made to ascertain whether these elements have aided accountability. Segregation of duties and clear delineation of responsibilities and duties are found to be crucial to aiding accountability. Regulatory and supervisory responsibilities were formally passed to the FSA in June 1998 under the Bank of England Act 1998. During this announcement, monetary policy independence was given to the Bank of England. However this was followed by another announcement on 20 May 1997 in which transfer of banking supervision from the Bank of England to the FSA, formerly known as the SIB, was made (See Statement by Chancellor of Exchequer, 6 May 1997)

Until the early 1970s, the Bank of England's ability to gather information was limited to the collection of monetary statistics and the informal monitoring of banking institutions (Hadjiemmanuil, 1995). The intensity of monitoring depended on the type of relationship an institution had with the Bank of England; more attention was given to discount houses and accepting houses (Hadjiemmanuil, 1995). During the Secondary Banking Crisis in 1973, UK bank supervision was managed by a group which consisted of 15 people. A personal approach to supervision was in existence at that time. However, following the Secondary Banking Crisis, a new Banking Supervision Division was established with the number of staff rising to 70 over three years. Thus the "personal approach" stance to supervision was reduced.

The Banking Act 1979 section 16 gave to the Bank of England "The Bank" power to compel "licensed deposit-takers", the lower tier of institutions authorized under the statute, to disclose any information that might be requested of them or to produce reports on such information by an accountant authorized by the Bank. The Bank was also given powers to appoint investigators who were to examine the affairs of an authorized institution. There was no attempt to depart from established cooperative supervisory practices of the Bank and the Bank's flexible, personal, progressive (tiered) and participative "supervisory style" was maintained despite the fact that under new licensing requirements, large numbers of previously unregulated institutions had been brought for the first time under the Bank's responsibility (Hadjiemmanuil, 1995: p 144). Following the collapse of Johnson Matthey Bankers in 1984, the Leigh Pemberton Committee was set up to review banking supervisory arrangements. The "tiered" approach was abandoned and the Bank's power to request information was extended to cover all banks in a move aimed at improving supervision (Hadjiemmanuil, 1995: p 144). There was also increased emphasis on the requirement by authorized institutions to maintain sufficient internal controls and the establishment of audit committees consisting of non-executive directors. A system of occasional on-site examinations was introduced where small review teams of supervisors along with accountants or bankers on temporary assignment from their firms to the Bank, visited usually for a period of a few days the authorized institutions for the purpose of assessing the quality of their lending and control systems or examining particular areas of concern (Banking Act of 1987).

Following the collapse of Johnson Matthey Bankers, the resulting legislation paved way for the establishment of a Board of Banking Supervision in May 1986 to assist the Governor of the Bank of England. The Board consisted of nine members, three of which were *ex officio* members, the Governor, Deputy Governor and Head of Supervision. Six outsiders provided expertise in the areas of banking, accountancy and law. The effectiveness of the Board of Banking Supervision was questioned after the Bingham Report (Inquiry into the Supervision of the Bank of Credit and Commerce International) observed that the Board lacked vital information to perform its duties. Following this incident, the level and detail of information received by the Board was increased. The Board met more frequently and was more involved in every aspect of the Bank's regulatory work.

The Banking Act 1987 vested in the Bank wide powers relating to the collection of information and the monitoring of authorized institutions. Schedule 3 of the Act covers the minimum criteria for authorization of an institution as a bank and provided foundation for the Bank of England's supervisory position. Apart from vesting in the Bank wide powers relating to the collection of information and monitoring of authorized institutions, the Banking Act of 1987 introduced the involvement of bank auditors in the supervisory process. The collapse of BCCI also led to the adoption of a more intrusive supervisory attitude (Hadjiemmanuil, 1995: p 146). The number of on-site bank examinations increased to about 120 to 130 visits per year in 1995 (Hadjiemmanuil, 1995: p. 146). However, supervision remained largely dependent on information received from the authorized institutions themselves and the introduction of bank examinations on a quasi-permanent basis, as is the case in the US supervisory system was strongly resisted. The BCCI crisis also brought further change within the organizational structure of the Bank led to two new divisions within the Bank: that for Monetary Stability and that for Financial Stability. The decision-making process within the Bank was hierarchical - with the junior supervisors being entrusted with day-to-day monitoring of authorized institutions and not being authorized to take corrective action where it appeared to them appropriate (HR Vieten, 1997: p. 140). A critical decision was taken only after full consideration of circumstances of the case and at a higher level by senior regulators – subject to the Governor's approval. The collapse of Barings Bank in 1995 highlighted the fact that no on-site visits had ever been undertaken and that two had been planned for that year. The style of supervision by the Bank was one still based on trust in the "blue blooded banks" that did not require supervision (Treasury and Civil Service Committee, 1995).

The remaining sections of this paper are organized as follows: In the following section, regulation under the Bank of England regime is examined. This is followed by a section examining regulation under the Financial Services Authority regime. Next, a comparison of regulation under the two regimes is provided. Finally, the paper ends with some concluding comments and a discussion of the limitations of the paper.

REGULATION UNDER THE BANK OF ENGLAND

Polizatto distinguishes regulatory systems into two: moral suasion versus legalism and hands-off versus hands-on approaches (HR Vieten, 1997: p.73). Britain's system is more in line with the persuasive hands-off approach – even though as argued by Vieten (HR Vieten, 1997: p.73), British banking regulation is also governed by law. The system of supervision adopted by the Bank of England was one based on an informal regulatory approach which was based on influence and trust. A shared sense of hostility towards government bureaucracy and statutory rules in the City resulted in banks submitting to the Bank of England's and the trade associations' persuasive powers (Moran 1986 :18, Vieten 1997: pp73,74) . The Bank also maintained regular contacts with the main banking associations. As a result of the nature of the relationship between the Bank of England and the government – the Bank of England being a representative of City interests, the Bank of England had an informal relationship with the banks. This informal relationship would no doubt have provided the perfect situation whereby the Bank could have been "captured" by the industry it was supposed to have regulated.

According to Roberts (Hadjiemmanuil, 1995: p. 180), the internationalization of London and the growth of non-bank financial institutions in the 1960s started eroding the Bank's powers of moral suasion. Moran also states that the Bank's approach during the Secondary Banking Crisis was driven by fear of bureaucracy and placed excessive trust in regulatees at a period when internationalization and innovation proved unworkable for a regulatory system based on trust (HR Vieten, 1997: p. 75). In order to find a balance between the perceived benefits of the traditional system and the demands of an innovative market, the Bank introduced a two-tier system of recognition where the traditional system was reserved for the first tier and more intervention envisaged for tier two (HR Vieten, 1997: p. 75). This approach was deemed flexible as preservation of the Bank's informal approach suited and adapted well to the changing market (Cooke, 1986: p 89). However, with the enactment of the 1979 and 1987 banking acts, a trend towards growing formalization and reduction in the personal character of supervision was observed, staff number having risen from 15 to 249(Bank of England, 1994: p 36).

The collapse of banks such as Johnson Matthey Bankers (later rescued), BCCI and Barings, not only led to calls for change in the way in which prudential supervision was carried out but also to changes in the legislative framework. The collapse of Johnson Matthey Bankers caused immense damage on the reputation of the Bank of England and exposed its supervisory practices as complacent – injuring its relationship with major British banks (Johnson Matthey v Arthur Young, 1989). These banks were annoyed at having to bear the costs of the rescue (Hadjiemmanuil, 1995: p.43). Apart from the abolition of the two tier system which had been in operation at that time, weaknesses in the supervision of large exposures and the adequacy of control systems were identified. A recommendation was made for the introduction of statutory arrangements for the exchange of information between auditors and regulators. Calls were made for the introduction of a new Board of Banking Supervision – which was supposed to put the Bank under increased accountability. Other measures by Parliament included the strengthening of the Bank's powers to require information and to commence investigations into the affairs of authorized institutions. The release of bank auditors from their duty of confidentiality to client institutions to the extent necessary for facilitating the communication of information of regulatory evidence to the Bank, was also facilitated.

The most credible reason for keeping regulatory action secret was that confidence in a particular institution could be damaged if restrictive measures against it became known – which may lead to unreasonable termination (Trade and Industry Committee, 1989-1990: p. 49). Under the Banking Act 1987 section 17, the only piece of information that the Bank made available about banking institutions was whether they were authorized by the Banking Act. As well as hindering accountability, regulatory secrecy also undermines market transparency. If it were "reasonably certain" that a financial institution was beyond the stage where it could be rescued, then public should be aware of the impending risks associated with such institutions. Such an institution should be disallowed from trading when it is obvious that it would only be wasting investors'funds. Detecting when to go public about such institutions' affairs and whether such affairs could be discovered on time is crucial. The collapse of BCCI resulted to the Bank of England being more willing to provide information about circumstances leading to the collapse and reduced to some extent the emphasis on confidentiality (Hadjiemmanuil, 1995: p 413). However despite the willingness of the Bank to publicize and explain its regulatory practices through speeches of its governors and directors, articles in the *Quarterly Bulletin* and appearances before parliamentary committees, the regulatory system then remained opaque to a large extent (Hadjiemmanuil, 1995: p 414). Existence of a statutory duty of regulatory confidentiality presented an impediment towards achieving greater accountability and transparency.

Following the Johnson Matthey affair, relations between the Bank and Treasury were damaged as the Chancellor had provided misleading information to Parliament in failing to mention a direct loan made to Johnson Matthey which went beyond the indemnity under discussion and of which the Chancellor himself was unaware (Hadjiemmanuil, 1995: p 414). After this incident, a solution was arrived at in which the Bank was always to consult the Treasury prior to committing financial resources to a rescue operation (Hadjiemmanuil, 1995: p 414). There also followed a more consistent approach to keeping the Treasury informed of impending problems – especially in situations where the failure or closure of an institution could have systemic implications or where a regulatory decision was likely to attract parliamentary questions (Hadjiemmanuil, 1995: p 414). Even though these arrangements did not improve the situation relating to accountability for the Bank's regulatory decisions (in particular since Treasury still declined responsibility to Parliament), the new arrangements improved the preparedness of the Treasury to face inconvenient questions (Hadjiemmanuil, 1995: p 407).

The duty of making reports improved transparency so far as the general policies underlying its regulatory decisions were explained in its pages. However, it had serious limitations as a means of increasing accountability to Parliament (Hadjiemmanuil, 1995: p 407). The figures published in the annual reports, as well as showing that the Bank actually refused authorization only to a small proportion of applicants, also showed that the powers of revocation and restriction were rarely used. "The Bank also does not give any indication of its activities relating to the informal preliminary vetting of institutions intending to apply for authorization"(Hadjiemmanuil, 1995: p 407). Investigations by Select Committees, and in particular the Treasury and Civil Service provided the only direct and possibly only effective means for parliamentary scrutiny of the Bank's regulatory activities (Hadjiemmanuil, 1995: p 408). Following the collapse of BCCI, the Treasury Committee was critical of the way the Bank had handled the matter and recommended a stricter supervisory approach (Treasury and Civil Service Committee, paras 61-89).

Shortcomings of the Bank of England which were also highlighted during the collapse of BCCI (Bank of Credit and Commerce, 1998) included the fact that the Bank had authorized BCCI as a licensed deposit-taker under the 1979 Act even though it did not know or understand the shareholding structure of the institution's group and as a result, could not confirm whether its controllers were fit and proper persons (Hadjiemmanuil, 1995: p 47). In addition, the Bank had not tried to stop BCCI from using a banking name even though it was aware that as a UK based second-tier institution, the institution was not entitled to do so. It was also highlighted that the Bank had not acted at all even though it had been aware of Luxembourg's inability to exercise effective supervision. BCCI's auditor Price Waterhouse was also blamed for failing to communicate fully to the Bank about the situation. After pressure from the US authorities, the Bank commissioned a report which led to the closure of BCCI. The recommendations in the report included (Bingham Report, 1992): The imposition on bank auditors of a statutory duty to report to the Bank all information they know or should reasonably know to be relevant to the exercise of its supervisory responsibilities under the Banking Act (Bingham Report, 1992, paras 3.43-3.45); the strengthening of communication systems within the Bank, to ensure that all critical information reached its senior officials (Bingham Report, 1992, paras 3.6); an increase in the Bank's responsiveness to allegations of wrongdoing and the more active investigation of suspect banks (Bingham Report, 1992, paras 3.9-3.10) and a closer involvement of the Board of Banking Supervision in the supervisory process (Bingham Report, 1992, paras 3.11). However, even though it was acknowledged that there had been deficiencies in the BCCI case, none of the Bank's staff was held to account.

Following the collapse of Barings, neither the Board of Banking Supervision Report nor the Andersen Review of Supervision considered a total overhaul in the Bank's approach to supervision. The predominantly "off-site" nature of the supervision undertaken by the Bank was lauded by the Andersen Review as being flexible and able to influence banks by persuasion and not just the force of law or detailed rules (Treasury Committee, 1996: p. xiv). The Treasury Committee however noted that it was partly due to the discretionary basis of the Bank's approach to supervision that there was limitation in its ability to detect events at Barings and that some of the measures proposed in the Bank's review would help reduce the scope for flexibility (Treasury Committee, 1996: p. xiv). According to the Bank's Review of Supervision (Treasury Committee, 1996: para 14), the Arthur Andersen Review (supported by the Bank's Review of Supervision), suggests that the use of formal risk assessment models will mean there is need "to bring the line supervisors into direct contact, on site, with a wider range of management".

Even though the Bank committed itself to addressing the problems posed by evaluation of internal controls at banks and to addressing internal communication at the Bank itself by dedicating an increase in the resources towards supervision, it maintained a defense of retaining a non-rules based judgmental approach to supervision (Treasury Committee, 1996: p. xv). The Board of Banking Supervision Report identified a number of lessons arising from the collapse of Barings and a series of 17 recommendations for the Bank (Barings Bank, Session 1996-1997: p. xiii, 1996). Of the original 17 recommendations, 15 were reviewed in detail with the Board (Barings Bank, Minutes, 1996: p 147). Table 1 includes all 17 recommendations stated by the Board of Banking Supervision.

Would it have been difficult to change the culture which had existed between the Bank of England and the City for many decades? This would have required radical reform which may have proved difficult to implement at once. "Rome was not built in one day" and cultural change is always a great challenge. It was clearly vital to transfer banking supervision to an institution which did not have a cozy relationship with the City. The proximity of the Bank with the City was a key factor in the weakening of its regulatory capabilities.

The Bank of England's 1996 Annual Report identified three core purposes of the Bank namely: maintaining the integrity and value of the currency, maintaining the stability of the financial system, both domestically and internationally and seeking to ensure the effectiveness of the UK's financial services (Bank of England, 1996: p 8). The Annual Report also goes on to explain that "in exceptional circumstances, the Bank may also provide or organize last resort financial support where this is needed to avoid systemic damage." Since banks are expected to take risks, it would be expected that the Bank would not aim at eliminating all elements of risk within the financial system. From the report on the Barings collapse (Treasury Committee, 1996; p, x), it was highlighted that the Bank could not fulfill its main objective of protecting the financial system without some assessment of the internal workings of the firms in the market – which included the quality of their management. It was also highlighted that guarding against systemic risk was vital to maintaining the integrity of the financial system. Another vital important evidence – the fact that lack of internal controls could lead to the demise of an institution was emphasized.

Table 1: Recommendations for the Bank of England

i) Go further in its role as consolidation supervisor[1]
ii) Seek to obtain a more comprehensive understanding of the non-banking businesses in a group and of how the risks in such businesses are controlled, as part of the task of understanding where the "significant" risks in the group lie. The Bank should meet the management of these parts of the group on a formal basis and the questioning should range widely.
iii) Prepare internal guidelines to assist its staff in identifying "material risks" in a banking group and in protecting depositors[2]
iv) Ensure that it understands key elements of the management and control structures of those banking groups where it is responsible for consolidated supervision[3]. It should receive prior notice of significant re-organization and of significant new operations being undertaken by such groups together with relevant reporting responsibilities.
v) The scope of returns currently submitted to the Bank should be reviewed.
vi) A senior director should take responsibility within each bank for the accuracy of returns and should sign the most important prudential returns. He or she should meet the Bank at least once a year.
vii) Solo consolidation of any active trading entity within a bank should be formally approved by the Executive Director in charge of supervision and surveillance or one of Bank's Governors.
viii) Internal guidelines should be prepared for Bank staff as to the procedures to be followed with respect to the granting and review of solo consolidation.
ix) Review its Memorandums of Understanding (MOUs) with the Securities and Futures Authority and with other UK regulators.
x) Extend its international co-ordination where possible signing MOUs and involving non banking regulators.
xi) Extend its initiative of meeting the internal audit departments of banks and where the Bank is consolidated supervisor, should extend this to include the group internal audit function. The Bank should also meet the chairman of the audit committee in case of large UK incorporated institutions.
xii) Review the number and skills of the staff it considers it needs for on-site visits and consultation on a range of capital market and other issues.
xiii) The scope of section 39 reports should be extended to go outside banks and outside the UK as necessary and could be used more flexibly[4].
xiv) Periodically require authorized institutions to widen reports commissioned into systems and controls to cover the preparation and inputting of data in major overseas locations.
xv) Extend its guidance to managers in relation to large exposures, requiring that existing concessions are formally reported to the relevant Head of Division on an annual basis and that breaches be reported upwards regularly.
xvi) Complete examination of the extent of issuance of comfort letters and guarantees.
xvii) Introduce an independent quality assurance review of its supervision of banks and regular reports should be made to the Board of Banking Supervision.

[1] Expertise from different areas (securities, insurance, banking) now operate within the FSA.
[2] Another difficulty detected in the Bank of England's supervisory regime was the role of voluntary codes issued as guidance – see First Report from the Treasury Committee Barings Bank and Int. Regulation at pg xv. It wasn't obligatory for all financial institutions to adopt certain codes and there was no formal mechanism to effectively police adherence to the code or punish those who disregarded its requirements.
[3] This highlights the importance of skills-mix which are present in FSA and importance of having a single regulator which benefits from knowledge of many sectors – as opposed to a specialist regulator.
[4] This is necessary due to the growing multi functional and international nature of firms.

REGULATION UNDER THE FINANCIAL SERVICES AUTHORITY

The FSA is the renamed Securities and Investments Board (SIB) which was set up under the *Financial Services Act 1986.* The FSA's regulatory objectives include maintaining confidence in the financial system, promoting public understanding of the financial system, securing the appropriate degree of protection for consumers and reducing financial crime (FSMA, 2000). Just a comparison of the aims and objectives of the FSA and the Bank of England highlight where their work and concentration is focussed. The focus on public awareness and consumers by the FSA is a testament to its commitment towards public accountability. The FSA's regulatory principles include: The need to use its resources in the most efficient and economic way (FSMA, 2000), the responsibilities of those who manage the affairs of authorized persons; the principle that a burden or restriction which is placed on a person, or on the carrying on of a regulated activity, should be proportionate to the benefit intended to be conferred in general by that provision (FSMA, 2000); 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 and the principle that competition between authorized persons should not be impeded or distorted unnecessarily (FSMA, 2000).

The statement of these objectives and principles provides for a clearer regulatory framework in comparison to those objectives of the previous regulator, the Bank of England - which was largely opaque as regards its aims. These objectives will be key to holding the FSA accountable as to how it operates. There have been debates relating to the order of priority of the objectives and whether some principles should be given as much priority as objectives. The consumer objective whilst ensuring that some accountability is afforded by the FSA towards consumers, has been considered by some to impose too much a burden on consumers (House of Parliament, 1999). In addition, Goodhart (1998) suggests that a single regulator may lack clear focus on the objectives and rationale of regulation.

According to Vieten (1197), banking regulation has followed two trends namely: that supervision has become increasingly formalized and reliant on quantitative tools and that regulatory duties are pushed down a regulatory pyramid to include external auditors and to enlist the resources of regulatees. According to the Core Principles (Basel Core Principles) for effective Banking Supervision 1997, an effective banking supervisory system should consist of a mix of both “on-site” and “off-site” supervision. The UK system involves both on-site and off-site supervision (Singh).

Off-site supervision involves the regulator making use of external auditors. Off - site supervision by the FSA (Use of External Auditors by the FSA), is based on the Supervision Manual (SUP). The SUP forms part of the regulatory processes section of the FSA Handbook and SUP 3 of this manual which deals with auditors, states that (Hitchins, Hogg and Mallett: p. 152). The FSA must ensure that auditors have the skill, resources and experience to enable them deal with the scale, nature and complexity of the bank and regulatory requirements to which it is subject; A bank must notify the FSA as soon as it has been informed that its audit is likely to be qualified; If the auditor writes to the bank about its internal controls, the bank must inform the FSA promptly of material issues; Auditors of banks must co-operate with the FSA by attending meetings and supplying information; The FSA may pass auditor's information relevant to their function as they are bound by the confidentiality provisions of FSMA 2000; Auditors ceasing to audit a bank must notify the FSA, without delay, of any matter connected with their departure which the FSA should know or if there is nothing they need to know about.

On-site work is usually done by the examination staff of the bank supervisory agency or commissioned by supervisors but may be undertaken by external auditors(Basel Committee, 2002). At present, the external auditor assists the FSA through a mixed system of supervision whereby the FSA inspects banks (on-site) and utilizes external auditors (off-site). The FSA expects banks to provide information voluntarily to deal with it in an open and co-operative way and tell it promptly about anything significant

(SUP 2, Hitchins, Hogg and Mallett: p. 152). If necessary however, the FSA can use its powers to obtain information, require the preparation of reports by skilled persons, appoint investigators and apply for a warrant to enter premises (SUP 2, Hitchins, Hogg and Mallett: p. 152). The FSA can also visit banks – with or without notification and a bank's employees, agents or representatives may be asked to go to FSA's offices and must be available for meetings (SUP 2, Hitchins, Hogg and Mallett: p. 152). Privileged communications need not be disclosed – unless the holder or subject is supervised or the subject gives consent, "Bank representatives must also give FSA representatives access to premises on demand during reasonable hours. FSA can also ask banks to provide information for other regulators".

Barings as well as highlighting the problems and gaps which existed with prudential banking supervision, poor regulation and supervision of multi function firms (bank and securities regulation), also highlighted the misleading problem of relying on the capital adequacy ratio as the sole source of determining a financial institution's well-being. Regulators impose liquidity monitoring measures on banks to meet specified minimum levels of withdrawals but such measures are precautionary against short-term cash flow problems rather than a situation of panic outburst (Gleeson, 2006). The level of confidence reposed in the public by the financial community is what sustains banks in modern times and this is strengthened by external checks which is given by credit agencies through scrutiny of published accounts and by bank regulation through prudential supervision (Gleeson, 2006). Prudential regulation however, is not the only way in which the FSA takes interest in the financial management of authorized firms – there is also the principle of ensuring that a firm operates with required minimum level of capital in order to reduce the consequences of failure (Gleeson, 2006).

Statutory requirements govern the minimum amount of capital which a bank must have (Gleeson, 2006). These have been established by UK and European legislation and from internationally agreed recommendations of the Basel Committee on Banking Supervision (Wagster, 1999). The FSA's approach to the calculation of the capital base and the capital ratios and the assessment of capital adequacy are set out in chapters of the FSA's Interim Prudential Sourcebook for Banks [IPRU (BANK)] (Wagster, 1999). This has been supplemented by FSA policy statement Individual Capital Ratios for Banks. In due course this will be replaced by the Integrated Prudential Source book (Hall, 1997). In addition, at the international level, the Basel Committee has issued far-reaching proposals to refine and develop the current approach.

A COMPARISON OF REGIMES

At the time of the enactment of the Banking Act 1979, it was expected that parliamentary control over and accountability for the Bank's general direction of regulatory activities would be achieved at various levels (Hadjiemmanuil, 1995: p 404). However, the handling of individual cases was realized to be a quasi-judicial matter in which responsibility was assigned to the Bank only – thereby excluding the Treasury (Hadjiemmanuil, 1995: p 404). The form of indirect political accountability whereby the Bank was accountable to Parliament through the Treasury had proved unworkable as Treasury ministers were powerless to intervene in the supervisory process. According to Hadjiemmanuil (1995) "The Bank would keep the Treasury informed about its regulatory activities but Treasury declined to reveal to Parliament the content of its contacts with the Bank. Common practice had it that Chancellors ensured they had been aware of specific actions of the Bank – relating to banking supervision and last-resort lending but they declined to take responsibility for any actions connected to such. The decision to rescue Johnson Matthey was attributed to being that of the Governor of the Bank and not that of the Treasury – even though the then Chancellor of the Exchequer and the Economic Secretary to the Treasury indicated their support of the Governor's decision."

Many questions have been raised in relation to the FSA's ability to be held accountable – given the all embracing nature of its role and concentration of powers. Such questions include (Ferran, FSMA Section

2) whether the FSA could be made sufficiently accountable to industry whilst avoiding regulatory capture, whether it could be made properly accountable to consumers without creating false perceptions and possible moral hazard concerns about the extent to which the regulatory system would protect them from financial risks and the mechanisms in place to hold it politically accountable since it is independent of government. Fears particularly relate to the discretion given to the FSA as to how best to meets its objectives (Treasury Committee, 1996) – even though many commentators (FSMA, section 8-9) have suggested that the regulatory objectives and principles provide a basis for legal accountability. As a result of consolidation of the responsibilities for financial regulation into a single regulator, there are less possibilities for gaps in accountability since there is clearer evidence as to who is responsible for what.

The FSA Chairman suggested that the "prime accountability route" for the FSA would be through Ministers to Parliament but some commentators have doubted the effectiveness of political accountability in relation to the FSA. Even though there is government control in that HM Treasury appoints the FSA Board, can order independent reviews of its financial affairs and commission independent inquiries into regulatory failures, the Treasury cannot intervene directly in the FSA's affairs apart from limited situations concerned with competition (FSMA, section 8-9: p 26).

As regards public accountability, the FSA is obliged to maintain arrangements for consultation with consumers and practitioners (FSMA, section 8-9). There are also concerns that the independence of the Practitioner and Consumer Panels would be compromised since they have been established by the FSA. However statutory roles were given to both the Practitioner and Consumer Panels and on the 18th June 2001, the commencement order giving these roles came into force. Section 11 of the *Financial Services and Markets Act 2000* brought an important part of the formal accountability of the FSA to the Panel into effect and provides that if the FSA should ever reject formal advice offered by the Panel, it should have to explain its reasons in writing (The Financial Services Practitioner Panel, 2005). In addition, the Practitioner Panel has a measure of independence from the FSA as its chairman cannot be appointed or dismissed without the approval of the Treasury (House of Parliament, 1999: p 56). A brief account of the mechanisms whereby the FSA is held accountable is summarized as in Table 2 (Houser of Parliament, 1999: p 54-57).

LEGISLATION, ENFORCEMENT DURING AND AFTER THE FINANCIAL SERVICES ACT 1986

The extent to which the FSA could be judged to be a better model of accountability will very much depend on its approach to rule-making and enforcement (MacNeil, 1999: p 743). The original rulebooks of the five self-regulating organizations (SROs) which existed under the Financial Services Act 1986 were perceived as being unduly legalistic and lacking in coherence (MacNeil, 1999: p 731). The "new settlement" introduced by the Companies Act 1989 helped to resolve these problems by introducing new provisions into the FSA 1986 Act which would help simplify individual rulebooks of the SROs and provide some consistency between them (MacNeil, 1999: p 731). The result of the "new settlement" was that the rulebooks of the SIB and the SROs were divided into three tiers namely: 10 general principles; 40 core rules which were a mandatory part of the SRO rulebooks and third tier rules made by the SROs (MacNeil, 1999: p 731). However, this three-tier structure changed on the advent of a new SIB Chairman in 1992. A move away from emphasis on rules and the structure of rules to compliance with the spirit of the rules and an emphasis on management responsibility for compliance was realized (MacNeil, 1999: p 731).

A number of problems related to enforcement arose from the FSA 1986. These included the relative inexperience of regulators in operating the system combined with the on-going process of development of the rules (MacNeil, 1999: p 739).

Table 2: ACCOUNTABILITY MECHANISMS OF THE FSA

The Treasury: The chairman and the Board of the FSA are to be appointed and replaced by the Treasury. The Treasury also has the role of approving other appointments in relation to the FSA, such as the independent investigator. The FSA is required to submit an annual report to the Treasury which must also be laid before Parliament. The Treasury will be able to commission independent reports on the economy, efficiency and effectiveness with which the FSA has used its resources. The FSA must also give the Treasury copies of any rules and guidance it makes. Where competition concerns exist about the FSA or its rules, the Treasury can instruct the FSA to remedy the problem.
Parliament: Since the FSA's annual report is to be laid before Parliament by the Treasury, the report will be available for Parliamentary scrutiny.
FSA Board: The FSA will be accountable to its Board. The Board is required to have a majority of non-executive directors. A non-executive committee of the board is charged with keeping under review the efficiency of the FSA's discharge of its responsibilities.
Independent Complaints Investigator: Such an investigator is responsible for investigating complaints about exercise of the FSA's functions. Investigator's appointment and dismissal requires Treasury approval.
The Public: The FSA will hold public meetings on the annual report where there must be reasonable opportunity for questions to be put before the FSA.
Consumer and Practitioner Panels: The FSA is required to consult both panels about how far its general policies and practices conform to its statutory duties. This statutory obligation also includes its regulatory objectives and principles.
Consultation: The FSA is obliged to conduct public consultation on rules which it proposes to make. This provision aims to ensure that rule-making powers are used in a way that is focused and transparent.
Statutory Immunity: The FSA and its staff are given statutory immunity from liability in damages for things done during discharge of their functions. This immunity extends to staff of the compensation scheme and does not apply to actions done in bad faith nor to damages arising under the *Human Rights Act 1998*.

Apart from the fact that the SIB/FSA had no power to fine under the FSA 1986, there was also the problem of identifying separate roles of the SIB/FSA and the SROs in enforcement (MacNeil, 1999: p 740). Although a number of changes were made by the introduction of the Financial Services and Markets Bill, some provisions were carried over from the FSA 1986 to the FSMB (See FSA 1986,s61(1) and FSMB clause 332; FSA 1986, ss 65-68 and FSMB clauses 166-169; FSA 1986,s 28 and FSMB clause 40; FSA 1986, s59 and FSMB clause 113). Under clause 98 of the FSMB, the FSA was given a general power to fine authorized persons and specific powers to impose civil fines related to market abuse. The FSA's powers of “monitoring and enforcement” are contained within section 6 of Schedule 1 Part 1 - section 6(1) of the FSMA which states that 'The Authority must maintain arrangements designed to enable it determine whether persons on whom requirements are imposed by or under this Act are complying with them.' Part III of Schedule 1 deals with penalties and fees.

The FSA Handbook describes the FSA's risk based approach to supervision. The FSA operates on a risk-based approach whereby it differentiates between regulated institutions and allocates resources to areas of greater perceived risk (Hitchings, Hogg, Mallett, p:120-121). It identifies three sources of risk namely (Hitchings, Hogg, Mallett, p:121): The external environment; consumer and industry-wide risks and the regulated institutions themselves. Furthermore, the FSMA 2000 requires the FSA to pursue its objectives by re-enforcing the responsibilities of senior management (Hitchings, Hogg, Mallett, p121). Risk, in particular risk to its four statutory objectives, is now used as the determinant for all regulatory activity, including overall strategy and development (Gray and Hamilton, 2006: p 25). It has the following stages (Hitchins, Hogg and Mallett, p:123-124): Identifying the risks to the statutory objectives; Assessing and then prioritizing the risks; Considering the probability of a problem occurring by considering factors such as business risk, external context and the firm's business strategy and decisions; Prioritizing its regulatory position by “multiplying” the impact of the problem (if it occurs) by the probability of the problem occurring, "in doing this it takes into account (i) Its confidence in the information on which the risk assessment is based; (ii) The quality of home country supervision – for overseas banks in the UK and (iii) The anticipated direction of change in the impact and probability gradings" (Hitchins, Hogg and Mallett, p124). Having completed these assessments, the FSA, taking into account the resources at its disposal, will decide on its regulatory response.

CONCLUSION

Overall, the FSA's risk based approach has led to a reduced role for auditors in banking supervision (Dewing and Russell, p 107). From 1 April 2003 to 31 March 2004, the FSA exercised its power under section 166 of the Financial Services and Markets Act 2000 to require firms to produce a skilled person's report in 28 situations (Dewing and Russell, p 107). This is a considerable reduction in investigations from the number of reporting accountants commissioned under section 39 Banking Act 1987 which frequently exceeded 600 reports annually (Dewing and Russell, p 107).

Although there has been a reduction in the FSA's use of external auditors when compared to the regime of its predecessor the Bank of England, it can still be argued that the FSA not only possesses better accountability mechanisms than the Bank, but that so far, it has used these mechanisms reasonably well. This is evidenced by the FSA operating on a more rules-based regime, providing greater identification of its role in enforcement and having a clearer set of principles. Effective implementation is definitely more important than the sole possession of accountability mechanisms. Issues within the FSA which need to be addressed include funding: The FSA is independent of and does not receive any funding from the government. To finance its work, it charges fees to all authorized firms that carry out activities it regulates "general powers to raise there fees are set out in schedule 1, part 111" (FSMA, para 17). Given the way charges are imposed on regulated firms, better accountability mechanisms should be in place for the way the FSA's costs are incurred. It is also arguable that its principle of utilizing its resources in the most efficient and economic way (FSMA s 2 (3)(a), should be elevated to the status of an objective.

In response to the FSA's ability to levy unlimited fines, the government has agreed that these fines should be set off against the FSA's other finance to reduce any incentive to maximize penalties and that the FSA should not be able to add its own costs to any levied fines (The Economist, 1999). On the 27th May 2005, a review of its funding regime was announced with the realization of the need to drive down costs. The period from the 1st April 2004 to the 31st March 2005 saw particularly the review of 2 aspects of the FSA's performance and this has provided sufficient, if not absolute evidence that the FSA has performed well so far. The first of these aspects involved examination of costs imposed on the regulated – this being done jointly with the Practitioner Panel (FSA Annual Report, 2004/05: p 5). The second was the examination of the effectiveness and fairness of the FSA's enforcement process (Statement by Chancellor of Exchequer, 6 May 1997)

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