Research Office
Legislative Council Secretariat

Information Note

Evolution of financial regulatory regime in the United Kingdom

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1. Introduction

1.1 Globally, the boundaries between segments (e.g. banking, insurance, securities and wealth management) within the financial sector have blurred as a result of decades of financial innovation and deregulation since the 1980s. Nowadays, various financial products are offered to customers in retail banks.[1] Following the outbreak of global financial crisis in the late 2000s, there was call for a fundamental reform of the financial system to address risks associated with financial institutions becoming "too big to fail" ("TBTF")[2] so as to rebuild a safer and more resilient financial system. Business diversification of financial institutions and the heightened concern over systemic stability pose new challenges to global regulators currently, as they need to strike a cautious balance between a couple of ostensibly conflicting policy objectives, in particular on how to maintain overall financial stability and protect consumers/investors on the one hand, but not to stifle competition and innovation on the other.

1.2 There are three major financial regulatory approaches/models in the world. First and foremost is the **sectoral approach** (or "multiple regulator model")[3], under which financial institutions and products are supervised by dedicated functional supervisors. Hong Kong has adopted this approach, with individual regulators overseeing banking, insurance, securities and mandatory provident funds. Under the **integrated approach** (or "super regulator model"), the single universal regulator is responsible for overseeing all financial

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1 Taking the United States as an illustration, the Glass-Steagall Act in 1933 used to prohibit commercial banks from being "principally engaged" in non-banking activities and products. Yet a series of financial deregulation moves culminating in the Gramm-Leach-Bliley Act in 1999 eventually lifted such ban. This practice then spread to other places, including Hong Kong. See Sherman (2009).

2 TBTF problems are generally associated with systemically important financial institutions which would cause significant disruption to the financial system once collapsed. See Financial Stability Board (2021).

3 The sectoral approach can be further divided into "institutional approach", under which the regulatory status is determined by the legal status of a firm (e.g. bank, broker-dealer, or insurance company), and "functional approach", under which the regulatory status is based on the business of the entity. See Group of Thirty (2008).

institutions and products (as seen in Japan and Singapore), largely because of a belief that oversight by multiple regulators is perceptively ineffective in the context of blurring business segmentation which may lead to confusion or conflict over jurisdictional lines under the sectoral approach. The **"twin-peaks" approach** aims to avoid over-concentration of regulatory duties in a single body, with one regulator specializing in safety and soundness of individual financial institutions, as well as their implications on financial stability at the macro-level, and the other one in consumer/investor protection and market integrity through regulating conduct of financial services providers (as seen in Australia).[4]

1.3 It is noteworthy the United Kingdom ("UK") is the only global financial centre which has gone through all three regulatory approaches since the 1990s.[5] At the request of Hon CHAN Chun-ying, the Research Office has reviewed the regulatory evolution in the UK over the past 30 years, with a view to identifying strengths and drawbacks of each approach in its context. This ***Information Note*** begins with a brief overview of global developments on blurring financial segmentation and evolving regulatory approaches after major financial crises over the past decade or so. After a quick discussion of the regulatory approach taken in Hong Kong, the next two sections focus on policy development in the UK with respect to its evolvement (a) from a sectoral approach to an integrated approach during the period of 1997 to 2013; and (b) further into the twin-peaks approach after 2013.

2. Global financial developments and major regulatory regimes

2.1 **The United States ("US") is the leading pioneer in blurring business segmentation in the financial sector**. After the enactment of the Glass-Steagall Act in 1933 during the Great Depression, commercial banks in the US were prohibited from engaging in securities activities, so as to safeguard financial stability. This regulatory approach seemed to have worked effectively till the 1970s, but increasing competition between various segments within the financial sector and emergence of innovative products gradually rendered the firewalls ineffective. Coupled with intensive lobbying for deregulation by the financial community, the Federal Reserve (i.e. the bank regulator in the US) began to loosen the restrictions and allowed commercial banks to step into securities business (e.g. municipal bonds and mortgage-backed securities) in 1987. After more rounds of relaxation, the Gramm-Leach-Bliley Act ("GLB Act") of 1999

4 Group of Thirty (2008) and Godwin (2018).

5 The UK first moved from a sectoral regulatory approach to an integrated approach in December 2001, upon establishment of the Financial Services Authority. After the bankruptcy of Northern Rock in 2007, the UK switched to the "twin-peaks" approach in April 2013. It will be discussed in detail in the subsequent sections.

finally removed all the segmentation barriers established in 1933. As financial companies can operate cross-segment businesses and after waves of mergers and acquisitions, banks have increasingly become "supermarkets" of all sorts of financial products.[6] This phenomenon soon spread to other places in the 1990s amidst an emerging trend of financial liberalization and globalization.

2.2 However, **while blurring segmentation, aggrandizement of the financial sector and increased connectivity between markets across places propelled economic growth globally, they also inadvertently sowed seeds of financial instability, as manifested in the outbreak of global financial crisis between 2007 and 2009**. Commentators generally attributed the meltdown to two major factors. First, it was US households' ballooning leverage upon easy mortgage loans in the housing market especially targeting borrowers with weaker financial positions (so-called "sub-prime mortgages"), with the ratio of households' aggregate net liabilities to GDP doubling from 35% in 1996 to 70% in 2006. Secondly, proliferation of complex financial products became channels for spreading sub-prime mortgage risks, not only in the US but also in other places of the world. According to an estimate by the International Monetary Fund ("IMF"), major banks in affluent countries suffered a huge loss of up to US$4.1 trillion (HK$32 trillion) in this crisis.[7] As for retail investors of debt instruments suffering heavy loss in advanced places, they accused banks of frauds and malpractices in selling such risky products and thus sought compensation afterwards.[8] There was also public discontent over the resultant economic downturn and the enormous bailout packages offered by governments to selected financial institutions. In the aftermath of the crisis, global regulation over financial institutions was tightened in the 2010s.[9]

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6 The proportion of income derived from non-banking business to total revenue of US banks was limited to 5% in 1986, but loosened to 25% in 1996. The rule was lifted in 1999 by the GLB Act, which is still in place. See Jackson (1987), International Monetary Fund (1999) and Sherman (2009).

7 In mid-2007, the correction in the US housing prices burst the bubble created by excessive sub-prime mortgage loans and high-leverage structured products, sparking panic and culminating in the bankruptcy of Lehman Brothers in September 2008, followed by collapse of other financial institutions not only within the US but also in other advanced places. Many places thus lapsed into their deepest economic recessions since the 1930s. See McKinsey (2009) and International Monetary Fund (2009, 2010).

8 Giron and Correa (1999), Bruegel (2017) and Buch et al. (2021).

9 Taking the US as an example, it tightened financial regulation by enacting the Dodd-Frank Wall Street Reform and Consumer Protection Act ("the Dodd-Frank Act") in July 2010, which prohibited depository banks from involving in proprietary trading and certain kinds of speculative investment. Also, the minimum capital requirement ratio for banks was raised from 4% to 8.5%, even reaching a high of 13% for a few very large banks. See Walter (2019), World Bank (2020) and Federal Reserve (2022).

2.3 Against this backdrop, **global regulators are thus facing a number of dilemmas in the oversight of different business lines of financial institutions now**. In short, they need to review their regulatory regimes and strike a right balance amongst policy objectives such as (a) mitigation of systemic risk; (b) safety and soundness of financial institutions; (c) protection of customers and investors; (d) fairness and efficiency of markets; (e) promotion of market competition and financial innovation; and (f) minimization of administrative cost in conducting regulatory reform.[10] Amongst the financial institutions, there are concerns over implications for their compliance cost from tighter financial regulation.

2.4 Broadly speaking, global regulatory authorities could choose from the three major regulatory approaches briefly summarized below and in a concise table (**Appendix**):

(a) **Sectoral approach:** It has remained the most common form of regulatory regime so far, even though a few places switched to other approaches after the global financial crisis. In line with traditional business segmentation, separate regulators are set up to oversee individual functional lines of business (i.e. banking, insurance and securities).[11] This approach is relatively straightforward and could avoid administrative cost in setting up a new regulatory regime. Yet as consistent rules need to be applied to the same business activity undertaken by different financial institutions, many regulatory authorities in this camp enhanced cross-segment coordination and mitigated regulatory overlaps after the global financial crisis.[12] Likewise, the regulatory regime in the Mainland was streamlined in 2018 upon merging of the banking and insurance regulators;[13]

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[10] Group of Thirty (2008) and Godwin et al. (2016).

[11] As mentioned in footnote 3, a kind of sectoral approach would delineate regulators' purview by business transacted rather than legal status of firms.

[12] In the US, the Federal Reserve set out main rules to regulate securities business of major banks, while the Securities and Exchange Commission and the Commodity Futures Trading Commission are regulators of the securities markets and conduct of securities firms (e.g. investment banks and broker-dealers). Reportedly, there is considerable regulatory overlap and duplication between them. In July 2010, the Financial Stability Oversight Council was set up under the Dodd-Frank Act, creating a new high-level platform for these regulators to rationalize regulations and resolve sectoral disputes. See United States Government Accountability Office (2016), Bank for International Settlements (2018) and Congressional Research Service (2020).

[13] Most recently in April 2018, a financial reform was implemented in the Mainland, merging banking and insurance regulators into one (i.e. China Banking and Insurance Regulatory Commission ("CBIRC")) for better consistency in oversight. Since then, the financial regulatory regime in the Mainland has been streamlined from four regulators into three regulators, namely the People's Bank of China, CBIRC and China Securities Regulatory Commission.

(b) **Integrated approach:** Singapore was probably the first advanced place opting to consolidate its banking, securities and insurance regulators into a single body (i.e. the Monetary Authority of Singapore) as early as in 1984. After the Scandinavian financial crises in the 1980s, many Nordic countries (e.g. Norway, Denmark, Sweden and Finland) followed suit, so did some advanced places (e.g. Japan, South Korea and Germany) in the 2000s. The appeal of an integrated approach lies with the belief that it can enforce more comprehensive and harmonized rules across financial segments on the one hand, and streamline oversight of financial institutions with multiple business lines on the other;[14] and

(c) **Two separate regulators on prudential and conduct regulation:** Generally known as the twin-peaks approach, this set-up was first pioneered in Australia in 1998, with the regulatory functions splitting between two mega-regulators. While one regulator is tasked with overall financial stability and soundness of individual financial institutions (i.e. prudential regulation at the micro-level) and the overall financial stability as well (i.e. macro-prudential supervision), the other focuses on protection of consumers and investors (i.e. market conduct regulation).

As Australia was left largely unscathed amidst the global financial crisis, some countries (e.g. New Zealand, the UK and South Africa) have adopted this regulatory approach in recent years. According to IMF and other global studies, the strengths of the twin-peaks approach lie in (i) its "dedicated objectives and clear mandates" to ensure proper balance between prudential regulation and consumer protection; and (ii) "optimal" number of regulators to avoid big and clumsy bureaucracy under the integrated approach as well as potential turf wars under the sectoral approach.[15]

2.5 Based on the studies of the World Bank and Organisation for Economic Co-operation and Development ("OECD"), **each regulatory approach has its own strengths and weaknesses.** There is "no perfect structural model" applicable to all places in a "one-size-fits-all" manner, and each government has to design a financial regulatory architecture best fitting the unique historical

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[14] Group of Thirty (2008) and Godwin et al. (2017).

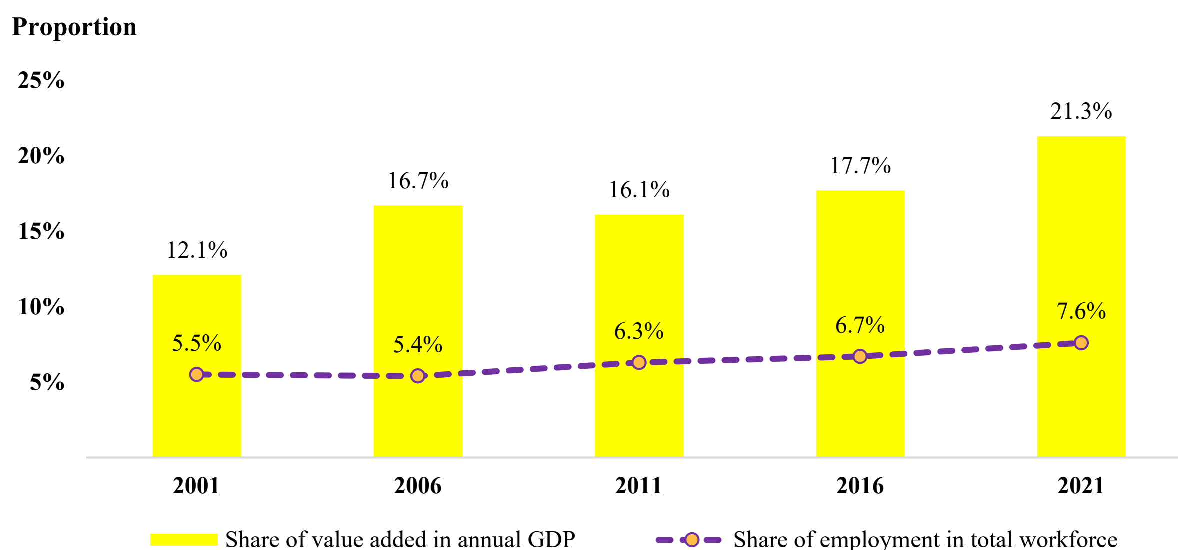
[15] European Central Bank (2010), International Monetary Fund (2011), Schmulow (2016) and Godwin et al. (2017).

situations and size of its domestic financial sector.[16] According to another study covering 79 sample places completed by the Bank for International Settlements in 2018, 38 of them (or 48%) took a sectoral approach in their financial regulatory framework, even though eight places have moved away from this approach over a decade after the outbreak of global financial crisis.[17] The number of places adopting an integrated regulatory approach had increased by two to 23 (or 29%) by 2019, and just nine places (or 11%) adopted the twin-peak approach though the number was up noticeably from five a decade earlier.

3. Financial regulatory regime in Hong Kong

3.1 Financial services in Hong Kong have continued to grow at a buoyant pace in recent decades, propelled not only by its "well-functioning" macro-prudential policy and "robust regulatory and supervisory frameworks", but also by its status as a "leading financial gateway" between the Mainland and the world.[18] Indicative of its rising contribution to local economy, the share of the financial sector's value added in GDP nearly doubled from 12.1% in 2001 to 21.3% in 2021 (**Figure 1**). Concurrently, it employed 7.6% of local workforce in 2021, up from 5.5% in 2001.

Figure 1 – Value added and employment of the financial sector in Hong Kong



Source: Census and Statistics Department.

[16] World Bank (2004) and Organisation for Economic Co-operation and Development (2017).

[17] Amongst these eight places, four established an integrated regulator, two streamlined their banking and insurance regulators into a single entity, and the remaining two shifted to twin-peaks approach. See Bank for International Settlements (2018).

[18] International Monetary Fund (2022a).

3.2 There are altogether four financial regulators in Hong Kong, namely the Hong Kong Monetary Authority ("HKMA"), the Securities and Futures Commission ("SFC"), the Insurance Authority ("IA") and the Mandatory Provident Fund Schemes Authority ("MPFA"). **In view of the aforementioned trend of business diversification, a frontline regulator approach has been adopted to oversee cross-segment business since December 2002**. In a nutshell, the regulatory authority over the principal business of a financial institution is also responsible for regulating its other lines of financial business on behalf of the other three regulators. Taking the banking sector as an example, HKMA is also tasked with supervision of non-banking financial services (e.g. securities, investment-linked insurance and retirement funds) of local banks in accordance with the rulebooks set out by SFC, IA and MPFA respectively.[19] In order to "minimize regulatory duplication or gaps" in cross-segment business, the four regulators signed a series of memorandum of understandings ("MoU") amongst themselves. They could also discuss supervisory issues through two cross-sectoral liaison platforms, namely the Council of Financial Regulators and the Financial Stability Committee (both set up in February 2003). Yet there is little publicly available information on their deliberation and their meetings.[20]

3.3 **Although the sectoral approach worked smoothly in Hong Kong most of the time, it did face a challenging period upon the bankruptcy of the Lehman Brothers ("LB")**, a major global financial institution at the time.[21] In September 2008, 43 700 local investors who had purchased LB-related minibonds and structured products through 16 banks in Hong Kong faced a total loss of some HK$20 billion.[22] They lodged over 21 000 complaints to HKMA, alleging malpractice of banks in selling risky products to retail customers on the one hand, and inadequate regulatory oversight by HKMA and SFC in preventing such misconduct of intermediaries on the other. In November 2008, the

[19] Likewise, SFC is the frontline regulator of securities firms offering insurance or retirement products on behalf of IA and MPFA. Same logic applies to insurance companies selling investment or retirement products, where IA is the frontline regulator for SFC and MPFA. See Gibson (2022).

[20] The Council for Financial Regulators is chaired by the Financial Secretary, with all four financial regulators as members. The Financial Stability Committee is chaired by the Secretary for Financial Services and the Treasury, with HKMA, SFC and IA as members. See Hong Kong Monetary Authority (2006) and Gibson (2022).

[21] Securities business of local banks flourished after the 1990s, with its share in total bank profits more than doubling from 7% in 2003 to 18% in 2007, in line with the global trend.

[22] Eligible retail investors of LB minibonds and structured products eventually could recover 86%-98% of their original investment value from the banks in mid-2011, upon the intervention of HKMA and SFC. Several local securities firms also distributed LB products. Between 2009 and 2011, SFC ordered them to compensate at least HK$96 million to the affected investors.

Legislative Council ("LegCo") passed a motion on "Reforming financial regulators", urging the Government to (a) review the financial regulatory regime; (b) plug the existing loopholes in the regulation; and (c) better protect the interests of investors.[23] In June 2012, after conducting a total of 106 hearings with major stakeholders in three years under section 9(1) of the Legislative Council (Powers and Privileges) Ordinance (Cap. 382), a dedicated subcommittee of LegCo concluded that the frontline regulatory framework over securities business of banks was "largely ineffective", suggesting that regulatory power "should rest with a single regulator".[24]

3.4 **At the instruction of the Financial Secretary, both HKMA and SFC reviewed the regulatory issues and recommended enhancement measures in December 2008.** The Government held the view that there was no need to "blindly follow any foreign experience", but saw the "pragmatic" need to refine the existing regulatory regime by strengthening its oversight of market conduct.[25] Since 2009, regulation on non-banking business of local banks has been tightened by HKMA, on top of those existing measures set out by other regulators.[26] The new measures include (a) physical segregation of non-banking financial activities from ordinary banking services in retail bank branches; (b) differentiation between bank staff selling investment and insurance products and those undertaking ordinary banking services; (c) audio-recording of face-to-face selling of non-banking financial products; (d) holistic assessment of product suitability for retail customers; and (e) a two-day cooling-off period for buying derivative products.[27] Likewise, SFC enhanced its oversight of intermediaries for investor protection, including (a) more disclosure of product features and commercial interest in the sales process (e.g. commissions and fees); (b) cooling-off period; and (c) establishing a cross-sectoral investor education centre to strengthen and popularize investors' financial knowledge. Moreover, HKMA and SFC enhance information sharing and conduct joint mystery shopping exercise to check the sale practices of banks, whereas the Financial Dispute Resolution Centre was set up in November 2011 to offer independent mediation of monetary disputes between financial institutions and their customers.[28] To align with practice in certain advanced places and respond to

23 Legislative Council (2008).

24 Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products (2012).

25 Legislative Council (2008) and Securities and Futures Commission (2008).

26 HKMA justifies the additional requirements for local banks due to their unique advantages of (a) extensive branch network in community; and (b) special trust from customers.

27 Apart from the cooling-off period, holistic assessment of risk profile of retail customers also applies to buying derivative products. See Hong Kong Monetary Authority (2009).

28 Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products (2012).

local banking concerns, HKMA however relaxed a few investor protection measures in September 2019.[29]

3.5 Although Hong Kong did not experience systemic dislocation during the global financial crisis, a number of measures to further fortify financial stability have been implemented over the past decade, including establishing a resolution regime[30] and introducing a countercyclical capital buffer for banks.[31]

3.6 Enhanced oversight of conduct of financial intermediaries appears to have functioned well over the past decade or so, as high-profile complaints on massive malpractice in sales of financial products are rarely heard in Hong Kong nowadays,[32] on top of overall financial stability and buoyant uptrend in the value added of the financial sector as discussed above. In fact, discussion in the public domain on overhauling the financial regulatory regime in Hong Kong has generally subsided in recent years, except sporadic academic studies.[33] IMF also acknowledges that the "robust regulatory and supervisory frameworks" are one of the key pillars for Hong Kong as a global financial centre.[34]

4. Super regulator in the UK for the period 2001-2013

4.1 London has long been a leading global financial centre for more than 170 years. Nonetheless, its global ranking receded from the top to the second position in March 2018, partly due to ramifications arising from the referendum on the departure of the UK from the European Union in July 2016. **Yet financial**

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[29] For example, the requirements of audio-recording, holistic risk profile assessment and a cooling-off period are now mostly confined to selling complex investment products to vulnerable customers (e.g. elderly or disabled persons and people with limited investment experience and wealth). See Hong Kong Monetary Authority (2019, 2021, 2022a).

[30] Effective resolution regimes can help safely resolve failing financial institutions, thereby protecting the continuity of critical financial functions and public funds. See Hong Kong Monetary Authority (2016).

[31] Banks are required to build up countercyclical capital buffer during periods of excessive credit growth when risks of system-wide stress are observed to be growing markedly. Meanwhile, Systemically Important Authorized Institutions (i.e. banks whose distress or failure could cause significant disruption to the financial system and the broader economy) are further subject to additional capital surcharges in the form of higher loss absorbency. See Hong Kong Monetary Authority (2022b, 2022c).

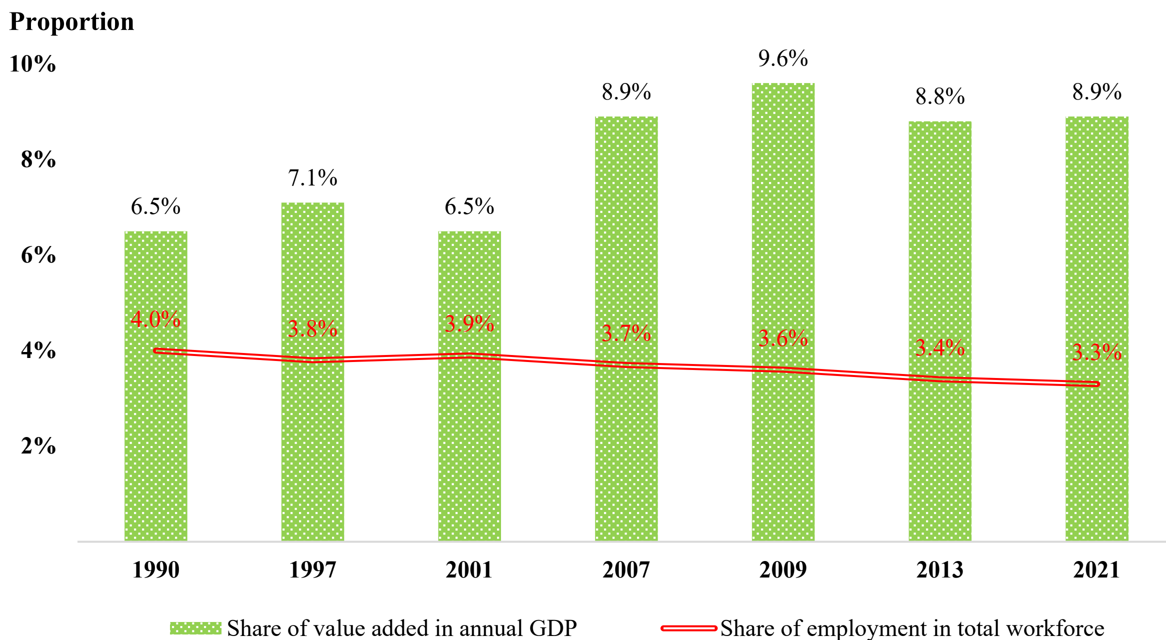
[32] Most recently in December 2021, in view of proliferation of online insurance products and insurance-linked securities, HKMA, SFC and IA jointly issued guidance to strengthen supervision on these lines of emerging insurance business.

[33] Michael (2014), Legislative Council (2022), GovHK (2022b) and Gibson (2022).

[34] GovHK (2022a) and International Monetary Fund (2022a).

services remain the "engine of the UK's economy", with the sector's share of value added in GDP surging from 6.5% in 1990 to a peak of 9.6% in 2009, before easing back to 8.9% in 2021 (**Figure 2**). Employment in financial services now accounts for 3.3% of the overall workforce in the UK, down from 4% in 1990.[35]

Figure 2 – Value added and employment of the UK financial sector



Source: Office for National Statistics.

4.2 Prior to late 1990s, the UK used to have as many as nine financial regulators (including self-regulatory bodies), as it was a usual practice to set up a new regulator to oversee emerging lines of business activity after the "big bang" of financial innovation and deregulation in the mid-1980s.[36] **Yet this traditional sectoral regulatory approach was reportedly too fragmented to supervise a single financial institution offering all sorts of financial products**. The alleged caveats of this framework included (a) overlapping or regulatory gaps due to a

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35 In London, financial services took up 17% of its annual value added and 7% of employment of the city in 2021. See Greater London Authority (2022) and Office for National Statistics (2022).

36 Before 1997, while the statutory Securities and Investments Board set out the rules for the securities market in the UK, these rules were implemented by three self-regulating bodies (namely Personal Investment Authority, Investment Management Regulatory Organisation and Securities and Futures Authority). The UK government directly supervised insurance companies, but regulation of brokers was left to Insurance Brokers Registration Council.

lack of clear allocation of responsibilities amongst regulators; (b) inability to reflect the market activities when distinctions between various types of financial institutions became blurred; (c) lack of statutory regulatory power for segments being supervised by self-regulatory bodies; (d) rising compliance cost on service providers; and (e) inability to protect small investors and lack of clear redress channels for them.[37] For instance, the Bank of England ("BoE") as the central bank was criticised for its incompetency in regulation of banks, resulting in bankruptcies of Bank of Credit and Commerce International in 1991 and Barings Bank in 1995. Meanwhile, there were scandals of securities firms (e.g. mis-selling of investment products and theft of fund assets) in the early 1990s and insurance market downturn due to complicated reinsurance activities between 1988 and 1992. There were thus mounting public concerns over the "regulatory blindness" and "lack of communication and cooperation" amongst the UK's financial regulators.[38]

4.3 **After winning the general election in May 1997, the new Labour government led by Tony Blair honoured its election pledge and proceeded with its reform to consolidate the regulation of banking, securities and insurance "under one roof"**. In July 1998, the Labour government introduced the Financial Services and Markets Bill to the Parliament, aiming to establish a single regulatory regime and vest full powers in the Financial Service Authority ("FSA").[39] During a two-year consultation and legislative process, the idea of an unified regulator was well-received and attracted "unanimous support" from major stakeholders and even IMF, largely because of its appeal of simplicity and "one-stop shop" for both financial institutions and customers alike. But some commentators cautioned that it would create a "bureaucratic monster" prone to the risks of small failure. The Financial Services and Markets Act was passed in June 2000 and came into effect in December 2001.[40]

4.4 For the next 11 years until March 2013, FSA became the integrated regulator of all financial institutions and financial services firms in the UK. The key features of this regulatory regime are summarized as follows:

(a) **Unified risk-based assessment:** FSA consolidated 11 separate regulatory methods from the old system into a single risk-based model to create "a common language" across all financial sectors. Under a four-grade risk categorisation scheme, each financial

[37] House of Commons (1997).

[38] House of Commons Library (1999) and Ferran (2003).

[39] FSA was the renamed Securities and Investments Board, which was set up under the Financial Services Act 1986.

[40] House of Commons Library (1999) and Ferran (2003, 2011).

institution was graded against a number of impact factors based on mathematical models. FSA would then determine the level of supervision and resource allocation for each institution;[41]

(b) **Principle-based regulation:** While supervision over market conduct still followed the sectoral rulebooks, FSA substantially streamlined the procedures in the mid-2000s. FSA also put emphasis on 11 broad-based principles it had set out to summarize the obligations of financial services firms under the regulatory system while complementing this with rules and procedures for regulated firms in an 8 000-page Handbook of Rules and Guidance. This translated into FSA's greater reliance on financial institutions adhering to its higher level principles, and a greater focus on the outcomes financial firms achieved for the interests of consumers and markets;[42]

(c) **Dedicated supervisory teams over functional segments:** FSA set up nine "sector teams" aligned with traditional business segmentation lines in supervision. Arguably, the previous multi-regulator model was entirely subsumed into FSA;

(d) **Single Financial Ombudsman Service for enhanced investor protection:** In June 2001, FSA integrated eight existing financial dispute resolution schemes into the Financial Ombudsman Service. It was mandatory for all regulated financial institutions to join so as to provide a single point of entry for consumer redress;[43] and

(e) **Tripartite arrangement for crisis management:** In March 2006, FSA signed an MoU with the Treasury and BoE to establish a coordinative framework for financial crisis management. If either agency identified a problem, they had to alert the others. The Chancellor of the Exchequer would then authorize interventions to reduce the risk of a "wider financial or economic

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41 In 2007, over 95% of regulated firms were categorized as low risk, with just 0.3% of them identified as high risk requiring "close and continuous" supervision. See National Audit Office (2007) and Financial Services Authority (2008).

42 Nevertheless, FSA recognized that there would be limits to implement a fully principle-based system. In some circumstances, detailed rules would need to play a role, for example where incentives for firms would be directly opposed to achieving regulatory outcomes. See National Audit Office (2007).

43 Joint Committee on Financial Services and Markets (1999).

disruption". Periodic tests were also conducted to develop their ability to withstand shocks.[44]

4.5 **The global business community hailed FSA as "a leading international regulator" in the mid-2000s, facilitating London's effort in cementing its position as the top global financial centre**. Not only did FSA integrate the allegedly fragmented regulatory system, the onerous rulebooks were also massively shortened to just 8 000 pages with some sections even trimmed by 40%. Also, while there was no major banking crisis under its watch in the next few years, FSA levied heavier fines for malpractice of larger institutions totalling £79 million (HK$749 million) during 2002 to 2007.[45] That said, there were still continued criticisms over inadequate oversight of the mis-selling of financial products (e.g. LB structured products and payment protection insurance) to retail investors. It was the outbreak of global financial crisis in the late 2000s that spelled the demise of the integrated regulator approach in the UK a few years later.[46]

5. Twin-peaks regime in the UK as from April 2013

5.1 Closely following the global trend in the banking sector, some financial institutions in the UK were heavily involved in lucrative but risky practice of funding their business expansion through debt securitization. Taking the Northern Rock Bank ("NRB") as an example, it was just the seventh largest UK building society back in 1997, but it embarked on an aggressive expansion of its mortgage business. It soon became the fifth largest mortgage lender in the UK in 2005, with its market share in mortgage lending more than tripling from 2% to 7.2% within less than a decade. Yet what made its business model unsustainable was its heavy reliance on the global wholesale market for funding (through securitization of mortgage loans and selling them to global investors), instead of more conventional and stable funding from deposits.[47] When the global funding was drying up upon the collapse of the US sub-prime mortgage market in mid-2007, NRB faced a severe liquidity crunch. Market panics led to a bank run on NRB on 14 September 2007 (the first in

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[44] Gibson (2022).
[45] House of Commons Library (2007) and National Audit Office (2007).
[46] Ferran (2011).
[47] While this sort of funding model could translate into handsome interest margins and profits in a buoyant market, it could expose the banks to great risks via surging funding costs when the market turned sour. As other major banks also engaged in risky business expansion, the share of securitized debt in total mortgage loans in the UK quadrupled to 18% between 1997 and 2007.

the British history in more than 140 years), resulting in a bailout by the UK government. With further rescues of three other banks (i.e. Royal Bank of Scotland, Lloyds Bank and Bradford & Bingley) in the next two years taken into account, the UK government had injected a total of £137 billion (HK$1.3 trillion) into financial institutions by end-2009 to restore overall financial stability.[48]

5.2 **In this episode of banking crisis, "inadequate regulation" of local banks and inability to "contain systemic risk" were alleged as key culprits**. More specifically on NRB, FSA was criticized for ignoring early failure signals in August 2007 on the one hand, and delayed policy response afterwards for about one month due to disagreement amongst the tripartite regulators on the other.[49] At the instruction of the UK government, FSA conducted a half-year review of the regulatory issues and came up with the following conclusion in March 2009:

(a) FSA admitted its failure in striking a proper regulatory balance between supervision of market conduct and prudential regulation, conceivably "biased towards the former". Also, it focussed too much on individual firms rather than financial stability of the whole system for prudential regulation;

(b) FSA was not "aggressive enough" in requiring banks to change from risky to prudent business models, partly due to misplaced confidence in the capability of self-correcting markets;[50] and

(c) FSA further acknowledged that it fell short of professional standards in handling the NRB crisis, undertaking to adopt a "more intrusive and more systemic" regulation on large complex banks afterwards.[51] But the reputation of FSA was deeply eroded in the UK, resulting in strong discontent over the integrated regulator approach in the society at large.

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48 Financial Services Authority (2009b) and House of Commons Library (2018).

49 Shin (2009) and Godwin et al. (2017).

50 Critics often considered FSA's principle-based approach as "light touch" and attributed this to its failure to respond to the global financial crisis. Yet FSA noted it had never used such a term for regulation. See Financial Services Authority (2009b) and The Guardian (2013).

51 Reportedly, FSA had dedicated supervisors for the 1 000 largest regulated firms, which supposedly would be conducive to developing effective working relationships, including senior level engagement, with those firms. See National Audit Office (2007) and Financial Services Authority (2009b).

5.3 **The UK general election held in May 2010 became the catalyst for regulatory reform again, as the coalition government led by David Cameron of the Conservative Party decided to dismantle FSA and move to the twin-peaks approach.** During public consultation, some commenters defended FSA and claimed that the banking crisis was largely a worldwide regulatory issue, opining that a switch to a new regulatory regime might not necessarily result in better oversight.[52] Nonetheless, the coalition government countered that only a radical reform could profoundly change the "regulatory culture and philosophy" of the existing "flawed system", and this was echoed by BoE and major stakeholders.[53] They argued that the monolithic FSA "did not work in practice", as expertise in different areas was required to safeguard overall financial stability at the macro-level and oversee market conduct at the micro-level. The outbreak of another scandal over the collusion of major global banks in manipulation of the London Interbank Offered Rate ("LIBOR") in June 2012 became the last straw to break the camel's back.[54]

5.4 **In December 2012, the Financial Services Act was passed in the Parliament for implementation of the twin-peaks regulatory approach in April 2013**. In short, the daily execution of regulatory power of FSA was split between two regulators, namely the Prudential Regulation Authority ("PRA") under BoE and the Financial Conduct Authority ("FCA"), an independent body. BoE also set up the Financial Policy Committee ("FPC") to advise both regulators on systemic issues, which was allegedly absent in the tripartite system before the crisis, as shown in the organization chart (**Figure 3**).[55]

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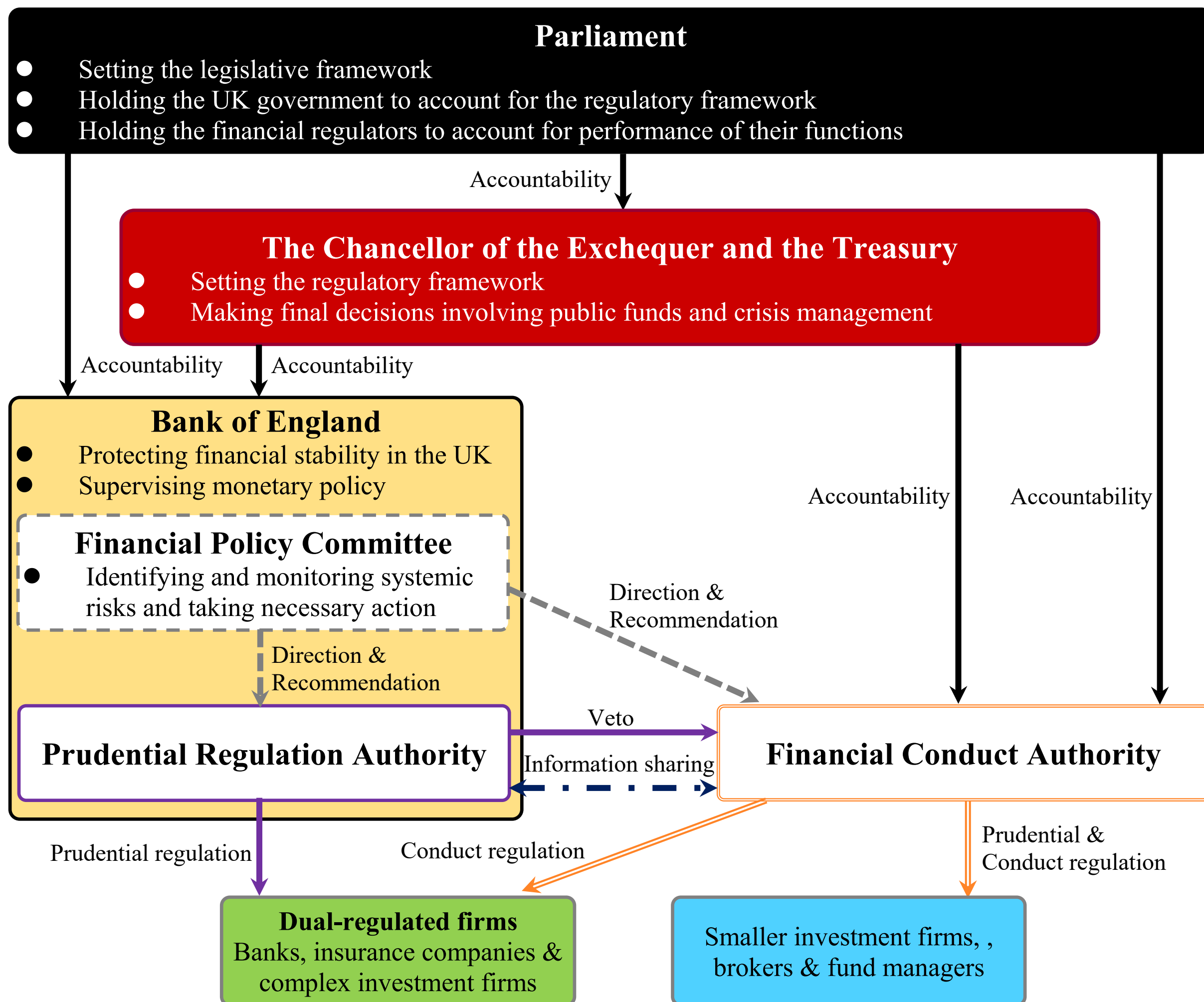
52 Ferran (2011).

53 HM Treasury (2011b) and Draft Financial Services Bill Joint Committee (2011).

54 Since 2007, a number of global banks colluded to manipulate LIBOR for lucrative profits. Although BoE sounded out early warning about it in 2008, FSA started the investigation only in early 2010. While FSA and FCA levied a total of £532 million (HK$5 billion) fines to those banks between 2012 and 2014, FSA admitted its regulatory failure again after a review in March 2013. LIBOR was eventually regulated by FCA under a new regulatory regime in July 2013. See Reuters (2013).

55 FPC comprises the Governor, four Deputy Governors (including the leader of PRA) and Executive Director of Financial Stability Strategy and Risk of BoE, the Chief Executive of FCA, the Director General of Financial Services at the Treasury and five external experts.

Figure 3 – Roles and accountabilities of the twin-peaks approach in the UK



Source: HM Treasury.

5.5 Following several rounds of legislative amendments for expanding regulated activities of FCA and rationalizing PRA's structure within BoE in ensuing years, here are key features of the UK's current twin-peaks regulatory approach:

(a) **Specialized regulators with well-defined objectives:** To tackle its perceived conflicts between prudential regulation and oversight of market conduct, FSA is now split into PRA for the former and FCA for the latter. The new regulatory regime thus has "clarity of responsibility" and "focused remits" backed by expertise specialization. Also, both regulators are more active to engage

regulated firms and intervene when there is such a need, contrasted against the earlier principle-based regulation of FSA;[56]

(b) **Policy priority of prudential regulation over market conduct supervision:** BoE resumes much regulatory power under the twin-peaks approach, as both FPC and PRA are under its command. Thus, BoE can compel additional regulations or overrule decisions of FCA (e.g. FPC's direction and recommendation and PRA's veto power) on an ad hoc basis under certain circumstances (e.g. potential threats to the UK's financial system), as post-crisis regulatory culture places more emphasis on reducing systemic risks and maintaining overall financial stability;[57]

(c) **Division of labour for prudential regulation between PRA and FCA:** PRA is specifically tasked to prudentially supervise 1 500 larger financial institutions (e.g. banks) to avoid another episode of TBTF crisis. For the rest 48 000 smaller institutions deemed to have negligible impact on the stability of the overall financial system, prudential regulation is delegated to FCA (on top of its purview of oversight of market conduct) because such supervision is conceived to be rather straightforward. This division of labour is meant to minimize the compliance cost of smaller institutions, retaining a familiar regulatory structure (supervised by one body) similar to FSA before;[58] and

(d) **Coordination for dual-regulated institutions:** According to MoU between PRA and FCA, PRA is the lead regulator over financial institutions subject to oversight by both regulators ("dual-regulated firms"). They routinely share information and assessment results of institutions with each other and may establish a working group when necessary on risk mitigation for individual institutions. But they seldom conduct joint supervision. Also, both regulators must review MoUs at least once a year to keep abreast with the latest market developments.[59]

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[56] Financial Conduct Authority and Bank of England (2019) and HM Treasury (2011b).

[57] Unlike in the 1990s, the promising performance of BoE in rescuing local banks during the global financial crisis had convinced the public that empowering the central bank with FPC and PRA would be "desirable" to minimize risk of regulatory gaps and "maximize the synergies" of having monetary policy and prudential regulations under one institution. See Godwin et al. (2017).

[58] HM Treasury (2011a).

[59] If there is ambiguity, the Treasury would determine the lead regulator of an investigation. See Godwin et al. (2017).

5.6 **Almost 10 years into the implementation of the twin-peaks regulatory approach, there has been no major financial crisis in the UK, notwithstanding adverse circumstances arising from the European debt crisis and then Brexit**. This may be attributable to the increased emphasis on prudential regulation and the overall stability of the financial system, along with tighter global financial regulations. IMF noted in February 2022 that the "robust oversight and supervision" in the UK is a key cornerstone behind its "resilient" financial system. Most recently in late September 2022, BoE won global acclaim for its quick response to inject emergency liquidity to avert market panics and a pension fund crisis triggered by a radical tax-cut budget proposed by Kwasi Kwarteng (the then Chancellor of the Exchequer with a short stint at the position).[60] There is also tighter oversight of market conduct, as FCA has levied a total fine of £43.8 billion (HK$415 billion) for financial misconduct over the past decade, compared with £603 million (HK$5.7 billion) for the 11-year period under the integrated regulator approach.

5.7 That said**, some stakeholders in the UK are still sceptical about whether the three regulatory entities (i.e. FPC, PRA and FCA) could coordinate their regulation in a seamless manner** under the twin-peaks regulatory framework and are concerned about the compliance cost of those dual-regulated institutions. There is also concern that FCA is responsible for supervising the conduct of a wide spectrum of small- and medium-sized financial institutions that could be very heterogeneous in nature and risk profile, thereby compromising its regulatory efficacy. As a matter of fact, there were still a few high-profile scandals over misleading promotion and sale practice of financial products (e.g. illiquid minibonds issued by companies or investment firms) in the UK between 2018 and 2019,[61] followed by failure of FCA to intervene earlier. In response to strong calls for remedial measures in Parliament, the UK government introduced an amendment bill to the Financial

[60] On 23 September 2022, the Truss government proposed a £45 billion (HK$427 billion) tax cut without stating its funding source. As investors worried about looming public debt and off-loaded government bonds in a massive scale in the next few days, a free fall in bond prices then caused heavy loss to pension funds which are heavily leveraged and/or engaged in liability-driven investment strategies. BoE was forced to buy bonds in a massive scale totalling £19.3 billion (HK$183 billion) in the next two weeks to pre-empt a financial crisis and to restore calm in the market. See Bank of England (2022a, 2022b), CNBC (2022) and The New York Times (2022).

[61] Over 16 000 UK's retail investors purchasing £319 million (HK$3 billion) worth of minibonds issued by three smaller local investment firms suffered a default upon their bankruptcies between 2018 and 2019. FCA was criticized for ignoring early signs of frauds via misleading financial promotion and sale practices of such products as revealed by the Police in 2018, hence the delayed action. See House of Commons Library (2021, 2022) and House of Commons (2022).

Services Act in July 2022, aiming to strengthen FCA's oversight on certain investment activities (including minibonds) and financial marketing. At this juncture, the amendment bill has not passed into law yet.

6. Observations

6.1 **Globally**, there are three major regulatory approaches in the financial sector, namely sectoral, integrated and twin-peaks approaches. Renowned studies by IMF, World Bank and OECD indicate that there appears "no perfect structural model" applicable to all places. Each regulatory approach has its own strengths and weaknesses, and each government has to design a financial regulatory architecture in the context of its unique demand, history and the structure of its financial sector.

6.2 The **UK** offered invaluable lessons in the merits and challenges for different regulatory approaches, being the only major global financial centre having gone through all three major regulatory approaches within a short span of less than three decades. Not only did these frequent changes in regulatory regimes result in significant administrative cost and regulatory uncertainty in transition, none of the three approaches proved to be a silver bullet for preventing inadequate regulation, especially in the context of fast-evolving market trends and rapid pace of financial innovation. Episodes of financial misconduct by practitioners or mis-selling by intermediaries were observed in all of the regulatory approaches in the UK. Even for the twin-peaks approach implemented for almost 10 years, although there has been no major financial crisis in the UK nor any visible problem in coordination amongst the three regulatory authorities observed thus far, there have been continued public complaints over market misconduct in selling risky products to retail investors in recent years.

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Appendix

Perceived strengths and weaknesses of the three financial regulatory approaches

	Features	Strengths	Weaknesses
Sectoral	• Sectoral regulators determined by legal status of a firm or type of activity engaged/business transacted by it • Examples: Portugal, Spain, Israel, Mainland China and Hong Kong	• Providing sector-specific supervision by expert regulators • Avoiding unlimited power dominated by one regulator • Generating new ideas via competition and peer benchmarking amongst regulators	• Regulatory inconsistency and higher compliance costs for financial institutions with more complex product offerings • Without effective coordination amongst regulators, there is risk of regulatory arbitrage where financial firms shopping around and registering in the least regulated sector, or regulatory gap where certain financial products/services are not under purview of any regulator • Turf wars between disparate regulators
Integrated	• A super regulator overseeing all financial institutions • Examples: Norway, Denmark, Germany, South Korea, Japan and Singapore	• Streamlined and harmonized regulation without confusion over sectoral lines • Reduced compliance costs especially for larger financial firms • Holistic oversight of the whole financial system	• Lack of specialization, thereby not conducive to nurturing expertise • Bureaucracy overburden by demanding workload and strained resources • No guarantee of effective cross-divisional coordination within the integrated regulator
Twin-peaks	• Division of labour by regulatory objective: One regulator tasked with prudential regulation and the other for market conduct oversight • Examples: Australia, the Netherlands, Belgium, New Zealand and the UK	• Clearer mandates between (a) systemic risks and financial institution soundness and (b) market integrity and consumer protection • Less likelihood of inconsistent rule-making and regulatory arbitrage • Suitable expertise deployed for specific objectives	• Regulatory overlaps and heavier compliance burden for dual-regulated entities • Potential conflict of interests between monetary and prudential policies (both supervised by central banks) and between prudential and conduct authorities • Higher regulatory costs

Sources: Bank for International Settlements, Federal Reserve Bank of Richmond, Turk and Llewellyn.

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Note: ^ Internet resources listed in this section were accessed in January 2023.