City Banquet at The Mansion House

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My Lord Mayor, Ladies and Gentlemen, it's a great pleasure to be here again for your autumn city banquet. This is the third time I have spoken here as Chairman of the FSA, and if you keep up the habit of inviting me, there will probably be one more such occasion.

The FSA is on the verge of major change – the division into the Prudential Regulation Authority and the Financial Conduct Authority – and from the FSA's viewpoint, once the decision was made to change to the new structure, the sooner we can implement that change the better. But the change requires major legislation, which deserves careful scrutiny by Parliament. And the parliamentary timescale means that implementation will not be before early 2013. So it is unlikely to be the last time an FSA Chairman addresses this gathering.

But it is the last opportunity to comment on the new regulatory structure before it becomes fixed. By this time next year the legislation will be finalised, and the key operational decisions – staffing levels, property, information technology – will be made.

So I'd like this evening to comment on the new regulatory structure, which will affect all regulated firms. And in particular to highlight remaining uncertainties and issues which merit consideration by Parliament and by society at large.

Focusing on future institutional structures might strike you as odd, ignoring the large elephant in the room. We are still in the middle of the most challenging financial crisis since at least the 1930s, arguably the worst in the history of modern market economies. The excesses of the pre-crisis boom have left us with a huge deleveraging challenge, the severity of which has become increasingly apparent over the last two years. Fears about the interplay within the eurozone of sovereign debt and bank solvency concerns are creating major bank funding pressures, which unless we are careful could produce a renewed credit crunch, setting back recovery throughout Europe. The US economy has not recovered at anything like the pace most commentators predicted only a year ago: there are some signs of slowdown in emerging markets.

Working out how best to navigate those challenges, and how best to ensure that the UK banks and other financial institutions are robust in the face of them, is clearly a more immediate priority than thinking about future structure, and I can assure you is the number one focus within the FSA.

And clearly it is vital that we see determined action by the eurozone authorities to address the sovereign debt uncertainties in a comprehensive fashion, and action to ensure bank capital adequacy, coordinated with the European Banking Authority on a European Union wide basis. But even as we navigate those challenges, we must also build a better system for the future. So it's on those future arrangements that I'll concentrate this evening.

There are three elements of the new structure – the Financial Policy Committee (FPC) , the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). Each will help ensure better results than in the past.

The Financial Policy Committee is a crucial element in the new structures. Indeed I believe it's the most important to address the failures that led to the financial crisis – filling the gap previously left between a central bank too exclusively focused on inflation targeting and a micro-prudential regulator too exclusively focused on individual institutions.

It is essential to have a body looking at the entire financial system, spotting vulnerabilities which are not apparent when you consider each institution alone. And essential to recognise that cycles of credit growth and asset prices can create financial stability and economic harm even when inflation is low and stable and economic growth appears steady.

So the overall design of the Financial Policy Committee – its objectives and responsibilities – is clearly right. But there remain important issues about how precisely the FPC will operate, and about how much we should expect it to achieve.

- The obvious issue relates to the tools which the FPC will deploy and with which Parliament needs to equip it. They will certainly include the ability to vary bank capital on a counter-cyclical basis. They should almost certainly also include the ability to vary key borrower focused levers – such as loan-to-value ratios in residential and commercial real estate lending.

  The shadow FPC has already set out some initial thinking on these levers in our recent press release, and will provide more detail as an input for Parliament's consideration early in the New Year.

And one thing which is crystal clear, but an area of significant concern, is that forthcoming European legislation must allow adequate flexibility for the national variation of macro-prudential tools. European capital adequacy regulation should enforce minimum standards across the European Union, but it should leave national authorities free to exceed and vary them above the minimum. The idea that securing the single market requires the harmonisation of maximum as well as minimum standards is simply wrong and potentially harmful.

- But alongside these obvious challenges relating to tools and the freedom to use them, we also need to consider carefully how much we can expect of macro-prudential policy and whether that is different in upswings and downswings.

Most of the arguments put forward for new macro-prudential policies, in various reports published after the crisis, focused on new tools to constrain future credit booms, 'taking away the punchbowl before the party gets out of hand'. And the importance of ensuring political independence has been much discussed – the need for an authority able to constrain credit booms even when that is unpopular.

But political independence to take unpopular action, to ‘take away the punchbowl’, is not the challenge today – the party is not so much out of hand as cancelled. And the issue with which the shadow FPC has therefore been wrestling, reflected in the record of the September meeting, is whether macro-prudential policy has any role to play in helping stimulate credit supply and activity in the downswing.

The answer is unclear – because in the downswing macro-prudential policy faces major dilemmas and uncertainties.

- If the downswing is caused – as it has been in this recession – by fears about financial fragility, then macro-prudential policy is on the horns of a dilemma. Uncertainty could argue for higher capital levels to mitigate market concerns about solvency and thus help to reduce pressures in funding markets. That is the rationale of the proposals currently under discussion about increased bank capitalisation across Europe. But a depressed economy argues for letting banks use up their capital and liquidity buffers in order to support credit growth.

- And even if the FPC did judge that capital and liquidity buffers could safely be allowed to decline, we cannot be sure that the banks will use this flexibility to support lending to the real economy rather than expanding other less economically vital activities, such as some inter-bank trading.

- And it is uncertain how much increased credit supply would actually stimulate borrowing in an environment where deleveraging may make reduced credit demand the dominant factor.

As a result, macro-prudential policy in downswings may at times, like interest rate policy, be ‘pushing on a string’, in which case stimulus will have to come from other policy levers. But we should not accept that conclusion as given. The FPC needs to continue debating whether any ‘push’ levers exist, and Parliament in its deliberations needs to consider carefully how ambitious are its expectations for what macro-prudential policy can attain.

- Should it be solely focused on financial stability – defined as banks which are solvent and liquid enough to avoid failure, and should it therefore be concerned with levels and trends in leverage or liquidity only insofar as they have implications for the financial soundness of financial firms themselves?

- Or should it focus on the adequacy of credit supply to the real economy as an end in itself, important for macroeconomic stability? If that is the focus, it will be difficult for the FPC to avoid making judgements about the relative importance of different uses of bank balance sheets. And if that is the focus, we may need to consider prudential tools which lean far more aggressively than in the past against the proliferation of intra-financial system complexity, the use of balance sheets to support inter-bank position-taking, which has been such a striking feature of the last several decades. And we may have to consider using macro-prudential levers which apply at the level of ring-fenced banks – such as those envisaged by the Independent Commission on Banking (ICB) – focused solely on core services to the real economy.

How the FPC operates in future will reflect in part the answer to these questions about objectives and tools.

Alongside the FPC we will have two distinct authorities.

- The PRA within the Bank of England, focused on ensuring that firms are financially sound.

- The FCA, focused on consumer and investor protection.

And this separation will, I believe, enable better focus on the distinctive approaches and skills required for good prudential and good conduct regulation and supervision.

For the FSA in its last 18 months, the key challenge will be to manage this separation while delivering business as usual amid the biggest financial crisis ever. The phrase ‘business as usual’, at present somewhat ironic. That’s a huge management task – but under the leadership of Hector Sants and his executive team – I am confident we will get there.

But beyond the implementation challenge, important issues about design and about society’s expectations still remain.

On the PRA side, the new authority will build on the new approaches to the regulation and supervision of banks and insurance companies that the FSA has put in place over the last few years, deepening and extending that transformation in the ways described in the PRA approach documents published in May and June this year.

Those documents highlighted one element of the proposed regulatory approach which is very easy to say but not easy to deliver: the idea that the failure of a firm should not always be seen as a regulatory failure, but in some circumstances as part of normal market discipline.

We are committed, in the UK and globally, to putting a stop to 'too big to fail' status, with resolution tools which can deal smoothly with the failure of a bank, however large.

The International Financial Stability Board has presented for approval by the G20 in Cannes, measures to ensure that effective resolution regimes are in place in all countries, and that bank specific recovery and resolution plans are in place for the most systemically important banks. And the ICB has, I believe quite rightly, proposed that banks should carry a defined tier of bail-inable debt, available to be converted to equity so that a firm can be resolved without recourse to tax payer support.

Much detailed work is still needed to bring these ideas to fruition – the challenges are particularly great when we deal with large complex cross-border banks – and here too the ICB has made an important recommendation, that if we have any doubts about the resolvability of a large complex cross-border bank, we should require still higher levels of loss-absorbing capacity than would otherwise be appropriate.

But assuming that we crack these implementation challenges, making all banks and other financial firms resolvable, there may still be an important challenge of social acceptance.

Because the implication of saying that we have fixed ‘too big to fail’ is that sometime in the future there may be a bank failure in which not only equity holders, but also subordinated debt holders and perhaps senior debt holders, and even perhaps uninsured depositors will suffer losses, and that fact will not then necessarily amount to regulatory failure. That is accepted already in the US, where the FDIC regularly resolves a significant number of banks even in good economic times. But it has not been an accepted and familiar part of our system.

So we need to be clear: there is no point in saying that we are abolishing ‘too big to fail’ status unless we mean it. And that means in future, provided a bank or another firm is resolved in a smooth fashion, that will not in itself indicate regulatory failure but might represent normal market discipline. That is the philosophy of regulation which the PRA approach documents set out; we need to recognise the implications.

In relation to customer and investor protection too, there will never be a no risk/no failure regime. But in the design of the FCA, we have committed to a new approach which will significantly reduce the incidence of major customer detriment. If that aspiration is to be reality, Parliament will need to equip the FCA with new powers, while recognising also the trade-offs inevitably involved.

The FCA will regulate both wholesale and retail financial services. On the wholesale side, continually evolving markets will create new regulatory challenges, but many aspects of past regulatory approach and market practice have worked well and do not need radical change. On the retail side, however, there are expectations that the FCA will mean not just a new structure but a new approach.

A new approach because the history of retail financial services over the last 20 years has not been a happy one: punctuated with too many waves of mis-selling – large scale customer detriment followed by large imposed compensation – personal pensions, mortgage endowment policies, split capital trusts, payment protection insurance. Total compensation paid over £15 billion and rising; and the number of complaints to the Financial Ombudsman Service up from 30,000 in 2000/01 to 200,000 last year.

At the core of these problems lies the complexity of many financial products and the inequality of knowledge between salesman and customer. The ordinary consumer can easily decide which car they want to buy, but not always which investment or insurance product. The price of a car is easy to understand; the true price of an investment product often complex. So the potential to sell products which carry more cost or risk than customers appreciate is ever-present; and particularly today when low interest rates mean low returns for truly safe investments, making consumers highly vulnerable to the promise of complex structured products which appear to offer the dream combination of higher return without higher risk.

In financial services the potential for the customer to be ripped off is simply far greater than in other sectors of the economy – and the consequences potentially more significant.

The challenge for the Financial Conduct Authority will be how to counter that danger.

In the past the FSA has attempted several different approaches, but it – and society at large – has been dissatisfied with the results.

We have focused on transparency of communications – clear explanation of product terms, clarity of pricing information – and that will remain a priority. But there is a wealth of evidence that it is insufficient.

And we have tried to use the indirect lever of focusing on processes and culture to ensure that firms think about what it means to treat customers fairly, and have processes to ensure that consideration of fairness balances the pursuit of immediate profit opportunity.

But that approach has been at best partially successful – while we were reviewing with major banks in the early stages of our Treating Customers Fairly initiative their processes to ensure fair treatment of customers, the same banks were selling payment protection insurance (PPI) not only to those customers for whom it might be a good product but to many for whom it was very obviously not.

Faced with that reality, the FSA signalled last year that we intend to switch to a different, more preventative approach, seeking to ensure that mis-selling on the scale of PPI is nipped in the bud earlier, rather than subject to *post-facto* compensation. The government's consultation paper in February this year picked up that theme, proposing that the FCA should have a 'greater willingness to intervene in the early stages of the product lifecycle…to deliver better outcomes for retail customers'.

And the FCA's approach document published in June this year stated that the FCA would be 'more ready to intervene, making full use of its powers, to tackle potential and emerging risk to consumer protection… before they materialise… in order to prevent large scale detriment'.

That intention makes sense – the pattern of the past is not acceptable. But new capabilities within the FCA and some new powers provided by Parliament will be needed to make it a reality.

Effective and targeted intervention will have to be informed by better analysis – of market structures, of customer behaviours, and of firm economics. The very high margins earned on PPI should have been a warning sign of potential problems – and for the FCA, understanding where firms are making money will be a key analytical tool. Many of the supervisory actions which may then follow will depend on the more robust use of existing powers, and hopefully, on a supervisory engagement with firms which recognise that they too have an interest in avoiding the problems of the past. But some new powers will be needed to give the new approach effective teeth.

- The power, if necessary, to demand changes in product terms or even *in extremis* to ban a product.

- And strengthened powers to tackle misleading financial advertisements, if necessary requiring their withdrawal.

This new approach, underpinned by some new powers, can, I am confident, make a difference. But we also need a realistic understanding that no system of regulation can or should try to create a 'nil risk' market environment.

- The FCA will regulate around 25,000 firms of hugely varying size and activity. The vast majority of these cannot be inspected or supervised directly at an acceptable cost to industry or to society. Inevitably many will continue to be monitored via scrutiny of submitted returns, supplemented by sectoral and thematic investigations of specific issues.

- In the mortgage market in 2007 there were around 12,000 different products. On the investment side, products continually evolve. Unlike in, say, pharmaceuticals, an in-advance product approval process is not practical.

So even in the best designed system, problems will still emerge. If there is another mis-selling wave as large as PPI, it will be fair to say that the new approach has delivered no better than the past. But even if the

FCA is successful, somewhere in the system, though hopefully on a smaller scale, customer detriment will arise which cannot be prevented in advance, with customers instead protected by their right to complain and, if appropriate, to receive compensation.

In the forthcoming debates that reality needs to be recognised and the trade-offs which the FCA will have to make, openly considered.

- The trade-off between more intense supervision and higher regulatory cost.

- The trade-off between seeking to identify and prevent problems early on, versus relying on a Financial Ombudsman Service to compensate consumers after the event. A trade-off which in part depends upon judgements about the value of financial innovation, which too forceful early intervention might stymie.

- The trade-off involved in any set of rules relating to customer redress. The natural assumption may be that wherever there has been a breach of regulatory rules and also customer detriment, that 100% redress should be available. But general principles of law mean that if the breach of rules did not without question cause the whole loss, then 100% redress is not available. Parliament could decide to change that balance, but that would involve a judgement about another trade-off.

- Which is the trade-off between regulation and customer choice, recognising that there are many products which are appropriate for some customers but not others, and that no system of regulation can prevent some customers making poor choices, or simply choices which they later regret, however clear the information provided and however fair and balanced the sales process.

Legislation will inevitably leave many of the details of these trade-offs to be struck by the FCA itself under the overall direction of its Board. But the more that these trade-offs are recognised in the forthcoming debates, and reflected in the final language of the forthcoming Act, the more likely that the FCA will be able to make appropriate choices which appear reasonable to society at large.

So my Lord Mayor, Alderman, Ladies and Gentlemen, I have not talked this evening, as you might have expected, about our still ongoing financial and economic travails, even though it is those which are most likely to keep me and the senior leadership of the FSA awake at night. But we have to plan for the future while navigating current concerns.

We have a major opportunity to put in place a better system of financial regulation – prudential, macro-prudential, and conduct. But we need to design the details carefully if we are to make the best of that opportunity.