Is Meta-Regulation all it's cracked up to be? The case of UK Financial Regulation

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ABSTRACT

One of the key components of regulatory regimes is the approach that the regulator adopts towards the supervision of the regulated. Regulators are therefore always looking for supervisory approaches that can increase compliance, by the regulated, with the requirements of the regulatory regime. Meta-regulation is one approach which has gained popularity in recent years. This article looks closely at the issues that arise when the regulated are closely involved in the regulatory process as a result of the use of meta-regulation. The article argues that the use of meta-regulation in the supervision of regulated firms is not unproblematic. The article uses the failures in UK financial regulation in the run-up to the global financial crisis as case-studies to illustrate some of the problems that can arise with the use of meta-regulation, and analyses some of the proposals for reforming UK financial regulation so as to overcome these problems.

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Key words: compliance, global financial crisis, meta-regulation, regulatory process, supervision, Northern Rock, Royal Bank of Scotland (RBS)

INTRODUCTION

The global financial crisis was caused by several factors, one of which is regulatory failure. As a result of the perception that the regulation in place prior to the crisis failed or was inadequate there has been intense debate on how best to improve financial regulation so as to prevent financial crises, or reduce their impact, in the future. This article uses the regulatory failure of the UK financial regulator, the Financial Services Authority (FSA), as a case-study to examine some of the issues that arise with the use of the increasingly popular regulatory technique of meta-regulation. In so doing, it highlights some of the weaknesses of meta-regulation and other regulatory strategies that prioritize 'market discipline' over a more robust approach towards implementation of the regulatory objectives and the supervision of the regulated firms.

The first part of the article is the introduction, which outlines the key issues that will be dealt with in the article. The second part of the article deals with regulation as a concept, by defining it and outlining the different components of a regulatory regime. The third part of the article examines meta-regulation in some detail- this involves defining it and discussing the benefits and problems associated with using it as a supervisory technique in a regulatory regime. The fourth part of the article uses UK financial regulation as a case-study of the use of meta-regulation in financial regulation. The fifth part examines the proposals for reforming UK financial regulation after the crisis and looks at the implications that such reforms will have for the use of meta-regulation in UK financial regulation in the future. The sixth part of the article brings together the different strands of the article to a comprehensive conclusion.

REGULATION: REGULATORY CONCEPTS AND THEORETICAL ISSUES

What is Regulation?

Regulation has been described as “sustained and focused control exercised by a public agency over activities that are valued by a community” (1). It has also been described as a specific set of commands applied by a body established for that purpose, deliberate state influence designed to influence industrial or social behavior and also, as all forms of social control or influence whereby all mechanisms affecting behavior are considered regulatory (2). Moreover, it has been defined as the assignment to a government agency of the responsibility of writing rules constraining certain kinds of private economic decisions, using a quasi-judicial administrative process to develop these rules (3). It is a politico-economic concept which is best understood by reference to different systems of economic organization and the legal forms that maintain them (4). More recently it has been referred to as “obligations imposed by public law designed to induce individuals and firms to outcomes which they would not voluntarily reach” (5). Regulation can, therefore, be viewed as the norms, policies, procedures and sanctions put in place in society (or a particular section of society) to secure the best possible outcomes through both the prevention of undesirable activities and outcomes, and also the encouragement or promotion of desirable activities and outcomes.

The different components of a regulatory regime

Most regulatory regimes can be broken down into a number of key components. The first is the aims or objectives of the regulation, and these will often be based on, or closely related to, some notion of the public interest that the regulation is designed to safeguard or promote. The second component of a regulatory regime is the framework of rules or regulatory standards that the regime is based on- these are important because the content and structure of the rules can affect the extent to which the regulatory regime will ultimately be successful. The third component is the institutional edifice of the regime, and this refers to the structure and number of regulators that will oversee the regime, as well as the powers and responsibilities that will be given to the regulator or regulators. The fourth component of a regulatory regime is the supervisory approach or the style of supervision, and this refers to the approach of the regulator towards the supervision of the regulated in order to achieve the regulatory objectives. It is, in effect, about the rigor with which the regulator carries out its supervisory functions as well as the policy considerations that govern how it implements the regulatory objectives and supervises the regulated so as to induce them, by persuasion or coercion, to comply with the rules of the regime. The final component of regulation is enforcement, and it refers to the sanctions imposed, by the regulator, on the regulated, for non-compliance with the rules. Enforcement is described here as the final component of regulation, although it is sometimes seen as separate from the regulation since the resort to enforcement often implies that the other components have failed. This article focuses primarily on the fourth component of regulation- the supervisory approach or the style of supervision. It examines the style of supervision that is popularly referred to as meta-regulation.

META-REGULATION AND ITS FEATURES

Meta-regulation refers to the methods that government or external regulators use to induce the regulated to develop their own internal, self-regulatory responses to public problems (6). It has been defined as a method where the regulator attempts to harness the regulated firms' risk management tools directly into the regulatory process and thus increase the penetration within regulated firms and individuals of the regulatory goals and objectives (7). The regulators direct the regulated to regulate themselves in a number of ways that range from explicitly threatening future discretion-eliminating forms of regulation and sanctions, to offering rewards to firms that opt for self-control (8). This involves the regulator identifying a regulatory problem or a public interest goal, and commanding the regulated to develop plans aimed at solving that problem, and then the regulated responding by developing their own internal regulations (6). It is, in effect, a method of regulatory supervision in which the regulator enrolls the regulated firms into the regulatory process.

There are many variations of meta-regulation currently in use in many areas of regulated activity. One variant of meta-regulation is the system-based approach to regulation. It is also known as the process-based or management-based approach to regulation (9). It is based on the idea that traditional or prescriptive approaches to regulation fall short because the regulated firms' production processes are too complicated for the regulator to be able to effectively prescribe regulatory fixes (9), and that therefore the regulatory objectives (which should reflect the public interest) can best be achieved by establishing the appropriate systems for monitoring production processes by firms (9). It is thus focused on supervising the regulated firms' systems and processes, rather than prescribing rules for the firms to comply with. It has been used in the regulation of food safety and industrial safety (10) and in the US Environmental Protection Agency's (EPA) 33/50 program (6). In system-based approaches to regulation compliance by the regulated firms is determined by whether they have acceptable systems and plans, rather than on the basis of detailed adherence to prescriptions or outcomes of the production process (9). It is therefore largely about the regulated firms' managements and their internal control mechanisms for addressing the risks (to the regulatory objectives) created by their businesses.

Another variant of meta-regulation is the performance-based approach, which is also sometimes referred to as the outcomes-based approach. Performance-based approaches are concerned with regulating for results while allowing firms the discretion to choose the best way to achieve the desired results (9). Under such approaches, the rule maker or regulator does not define the detailed processes or actions that the regulated should take, but instead merely outlines the outcomes that they require the regulated to achieve (11). The regulated are then allowed to decide on, and implement, whatever processes or actions they want to use to achieve the regulator's stated objective. A key rationale for performance-based approaches is that the regulated firms and their agents are better placed (than the regulator) to find the most efficient ways of achieving the objectives or outcomes required (11). Examples of performance based approaches are the UK FSA's principles-based approach to regulation (12) and the New Zealand building safety regime in the 1990s (9, 13).

The choice of meta-regulation as a regulatory technique hinges on a number of factors. These include the regulatory objectives that the regulator wants to achieve, the resources available to the regulator, the degree of accountability that meta-regulation provides and the likelihood that it can be properly implemented. The rest of this section looks at some of the strengths and weaknesses of meta-regulation.

Strengths of Meta-Regulation

One of the key strengths of meta-regulation is that it relies on the regulated firms to implement the regulation and this is advantageous because the firms often know more about the risks generated by their activities. Regulators are likely to be at an information disadvantage compared to the regulated industries they oversee, particularly in newly developing markets such as nanotechnology (14). The same can be said of rapidly evolving industries such as finance. Meta-regulation, however, allows the regulator to exploit the regulated firms' information advantage by leveraging the regulated firms into the task of regulating themselves (6). By allowing the regulator to overcome its information disadvantage by enrolling the regulated firms into the regulatory process meta-regulation offers the regulators increased potential for success in achieving their regulatory objectives.

Another significant strength of meta-regulation is that it gives the regulated firms substantial discretion since they are enlisted into the regulatory process or encouraged to develop their own internal systems of regulation (6). Giving the regulated firms this discretion can be beneficial because they are more likely to be able to find the most cost-effective solution to the problem at issue and they are likely to view their own methods or procedures as more reasonable than those imposed by outsiders and will therefore be more likely to comply with them (6). Meta-regulation therefore increases the likelihood of the regulator achieving its objectives since it provides the regulated with incentives to comply with the regulatory requirements.

A third benefit of meta-regulation is that it allows regulators to get around the problem of how to effectively use their often scarce resources. By bringing the regulated firms into the regulatory process meta-regulation compels them to invest some of their resources in management efforts aimed at public problems instead of expending all of their resources on activities that generate only private returns (6). In addition, the fact that meta-regulation does not require the regulator to have a detailed understanding of the relevant technologies makes it less costly to implement (15).

A fourth benefit associated with meta-regulation (particularly the performance-based approach) is the potential to avoid the problem of 'creative compliance' (16). Creative compliance is a problem which arises, to a greater extent, with the use of detailed rules or prescriptive regulation. It involves the regulated engaging in box-ticking and mechanical compliance with the provisions of detailed rules while at the same time doing things which are fundamentally at odds with the intention or objectives of the regulator or the regulator's rules (17). A good example of this is the Enron scandal in the early 2000s where the executives at Enron, along with their accountants, were able to comply with US accounting laws while at the same time deceiving the world as to the profitability of Enron, which had become insolvent (18). Broad rules which are outcomes-focused are better able to avoid this problem because they aid regulators in policing the 'spirit' as well as the 'letter' of the law (11). Such broad or outcomes-focused rules or standards will be a feature of performance-based approaches to regulation, and to this extent performance-based approaches are better able to avoid the problem of creative compliance.

Outcomes-based rules are also easy to apply, monitor and enforce, especially if they have been developed through a process of dialogue and consultation between regulators and regulated (19). Placing the regulated firms in more direct control of firm-specific hazard reduction instead of using a central, one-size-fits-all process designed by a regulator or other government agency can produce behavior (on the part of the regulated) designed to prevent problems before they occur (20). This again suggests that performance-based approaches are beneficial.

Problems associated with meta-regulation

Arguably, the most significant problem associated with meta-regulation is the fact that although businesses might have better information and greater resources to find solutions to public problems, they do not always necessarily have better incentives to do so (6). Meta-regulation is intended to capitalize on the fact that the regulator is not the only player in the regulatory space, by trying to co-opt the private institutions (the regulated firms) into the regulatory process, and to transfer responsibility for achieving regulatory objectives unto such non-state actors, by harnessing private capacity to secure compliance with the regulatory goals (20). This is, however, largely dependent on being able to closely align the regulated firms' 'private interests' with the regulator's 'public interest' objective. Failure to align both interests will mean a greater chance of the regulated firm not allowing itself to be co-opted since it is more likely to prioritize its own private interests over the regulator's public interest objective. This problem is particularly pronounced in an industry like the financial industry where greed and self-interest are major motivations for entering into the industry and the members have plenty of opportunity to act in a self-interested manner. It points to a significant theoretical flaw with meta-regulation: if the regulated are unable to behave properly on their own and there is the need for externally imposed regulation, then it makes no sense for the external regulator to devolve responsibility for the regulation (through meta-regulation) back unto the regulated.

Apart from greed or self-interest another factor that could undermine meta-regulation is incompetence or ineptitude of the regulated firms. Meta-regulation assumes that the regulated firms have more information about, and have a better understanding of the implications of, their activities than anyone else. The recent global financial crisis has, however, shown that, in addition to greed, individuals and firms in the financial industry can be susceptible to staggering amounts of incompetence and ineptitude- the firms failed to correctly measure, price and mitigate the risks generated by their activities. They failed to correctly measure the levels of risk they were taking on, and grossly underestimated the risks inherent in the businesses they were involved in. Moreover, they often failed to focus on the risks that affected them the most (21-22), and their over-reliance on mathematical risk models led them to become over-confident about their ability to predict and to mitigate risk. In addition, they failed to fully understand the difference between risk (which is calculable) and uncertainty (which is incalculable) (23-24). The financial crisis thus shows how the ineptitude of the regulated can lead to problems with meta-regulation.

Another problem with meta-regulation is the potential for shortfalls in accountability that can arise in meta-regulatory regimes. May (2007) uses the examples of meat production under HACCP, leaky buildings, nuclear safety and fire safety to show that the shift from bureaucratic accountability to professional accountability that accompanies the movement from prescriptive or traditional regulation to meta-regulation can lead to accountability shortfalls that are highly problematic (9). System-based approaches used in the nuclear industry, for example, that emphasize professional accountability over bureaucratic accountability undermine the ability to instill the requisite safety culture in the nuclear industry for a number of reasons including the lack of established professional standards for emergency preparedness (9). Performance-based approaches are also problematic since they seek accountability for results or outcomes and the problem with this is that predicting results can often be difficult or even impossible (9).

A further problem with meta-regulation is that it can potentially encourage regulatory inertia. This is because the devolution of regulatory processes, by the regulator, to the regulated can encourage the regulator to become complacent, because it believes that there is not much left for it to do since the regulated have been enrolled into the regulatory process and are doing everything that needs to be done. This is problematic because it can lead to a situation where the regulator over-relies on market discipline as a regulatory tool. A good example of this is the FSA's emphasis on 'light touch' regulation, which was largely based on the ideological belief that markets are self-correcting and, as a result, market discipline is a more effective tool than regulation or supervisory oversight- an ideological belief that has largely turned out to be incorrect (22, 25). This regulatory philosophy also underpinned the approach to regulation in the US (26), where it has also been found to be incorrect (27-28). In addition to over-reliance on market discipline, the devolution, by way of meta-regulation, of regulatory responsibilities can lead to confusion as to what the responsibilities of the regulator and the regulated are. Meta-regulation, by lending itself to the possibility of over-emphasis on market-based solutions (rather than regulatory ones) and confusion on the respective roles of the regulator and the regulated, offers the real threat of regulatory inertia that can prove detrimental to the regulatory objectives.

Another problem associated with meta-regulation is the fact that it can potentially lead to regulatory capture- the hallmarks of meta-regulation are increased discretion and flexibility, and these can easily lead to the corruption, or even the capture, of the regulator (29). The failures of performance-based regulation when used to regulate building industry standards in New Zealand show that the problems associated with regulatory capture are not necessarily eliminated by meta-regulation, but often reappear in more subtle forms (9, 13). Regulatory capture is a significant problem, and the fact that meta-regulation can potentially lead to it makes the use of meta-regulation potentially very problematic.

THE FAILURES OF META-REGULATION IN UK FINANCIAL REGULATION: THE NORTHERN ROCK AND ROYAL BANK OF SCOTLAND (RBS) CASE-STUDIES

This section outlines the failures of meta-regulation in UK financial regulation. It opens with a description of how meta-regulation is used in UK financial regulation. It then outlines how the global financial crisis unfolded and the role that the FSA's regulatory failure played in the collapses of Northern Rock and the Royal Bank of Scotland (RBS). The last part of this section then explains how the problems associated with meta-regulation manifested themselves in the FSA's regulatory regime and contributed to its regulatory failures.

How Meta-Regulation is used in UK Financial Regulation

The three most significant aims of financial regulation are maintaining systemic stability, protecting consumers and maintaining the integrity of the financial markets (30-31). In the UK the FSA's statutory objectives are connected to these aims. The FSA's statutory objectives are the protection of consumers, maintaining confidence in the financial system, maintaining the stability of the UK financial system, reducing financial crime and promoting public understanding of financial matters and the financial system (Financial Services and Markets Act (FSMA) 2000, sections 2(2) and 3-6A).

The financial regulation regime in the UK in the run-up to the global financial crisis has a number of features which are indicative of the use of meta-regulation. Key components of the regulator's Handbook have been implemented in a meta-regulatory fashion. The Principles for Firms (PRIN) and the High Level Statements of Principle for Approved Persons (APER) highlight the principles-based nature of the regime. A key feature of this principles-based regime is greater reliance on outcomes-focused, broad rules and less reliance on detailed or specific rules (12). This focus on outcomes is typical of a performance-based approach.

Another key component of the Handbook is the obligation it puts on the senior managements of the regulated firms to maintain adequate and effective systems and controls (SYSC). It requires a regulated firm to “take reasonable care to establish and maintain such systems and controls as are appropriate to its business” (FSA Handbook, SYSC 3.1.1). It highlights the fact that UK financial regulation has moved away from being merely about the regulator describing the prescriptive rules and compliance processes it sets out for the regulated firms, and now extends to how the senior management of regulated firms manage or run their firms. To this extent, SYSC makes the regime more management-based (system-based).

The regulatory philosophy of the FSA also points strongly to a preference for meta-regulation. Its approach to supervision can be characterized as risk-based in the sense that the regulator is concerned to limit or address the risks that it will not achieve its regulatory objectives and thus focuses on the risks that the regulated firms and their activities pose to it (the regulator) achieving its objectives (32-33). It also requires that the regulated firms have adequate internal risk management systems, and it relies on their senior managements to be aware of and to understand the risks that arise in relation to their business (FSA Handbook, SYSC 1.2 and 7). The accompanying Guidance on how to implement SYSC, for example, highlights, among other things, that the regulated firms should take steps to assess the risks that they face, with the goal of setting and controlling their risk exposure (FSA Handbook, SYSC 3.2.10). The reference to the regulator’s objectives gives its risk-based approach to regulation a performance-based flavor, while the reliance on the senior managements of the regulated firms to have in place adequate risk management systems gives it a management-based (system-based) flavor. It can therefore be argued that the FSA’s idea of risk-based regulation ties in strongly with meta-regulation.

Another aspect of the FSA’s regulatory philosophy, in the run-up to the global financial crisis, which also points to a preference for meta-regulation is the idea of ‘light touch’ regulation. It is characterized by reluctance, on the part of the regulator, to interfere with how the regulated firms conduct their business, and a preference for its regulation to be implemented in a business-friendly manner (34). This idea of light touch regulation has however been criticized as one of the contributors to the regulatory failures in the run-up to the crisis (22, 35) and as a consequence it has now been done away with.

The FSA's Regulatory Failure in the Regulation of Northern Rock

The financial crisis is a global phenomenon but the FSA, the UK's financial regulator, does bear some of the responsibility for the problems affecting the UK financial industry. All across the globe, deregulatory measures coupled with the excessive use of financial innovation led to a significant deterioration of risk controls for the extension of credit, thus fuelling asset price and house price bubbles in several countries including the UK and the US (36). The banks furthermore adopted an originate-to-distribute banking model, whereby they re-packaged the loans and mortgages that they had made and turned them into marketable securities (Residential Mortgage-Backed Securities (RMBS) and Collateralized Debt Obligations (CDO)) that could be traded on global capital markets (37). This came to be a major source of funding for many of the banks. When the house price bubble burst, and huge numbers of borrowers began defaulting on their mortgages, the losses spread to the hedge funds, banks and other capital market investors who were the main buyers of the RMBS, CDOs and other such Asset Backed Commercial Products (ABCP) (38). This practically removed all demand for these marketable securities thus leading to a shortage of liquidity in the global credit markets.

This drying up of funds in the global capital markets caused Northern Rock plc, a bank in the UK, to experience serious difficulties in obtaining funding from the capital markets (39) and it ultimately suffered a bank run and had to be nationalized. It was more badly affected (by the drying up of funds in the capital markets) than other UK banks because its business model was "fundamentally flawed"- it had over-relied on funding from the wholesale capital markets (38). It had failed to adequately diversify its funding sources and to adequately insure itself against the problems it faced (39). It had therefore failed to properly manage the risks to its business and its senior management had failed to put in place effective systems and controls to ensure that it would not encounter the problems that it encountered.

The UK regulator, the FSA, has been criticized for failing to properly address the weaknesses that Northern Rock's funding model posed to its regulatory objectives- this has been described in a Parliamentary Report as a significant regulatory failure (39). The FSA, using its risk-based approach to regulation, had classed Northern Rock as a high impact firm (a firm that should be closely supervised because it could potentially have a significant impact on the regulator's statutory objectives) (39), but nevertheless failed to carry out regular supervisory assessments of the bank (40). It also failed to ensure that the bank maintained adequate liquidity and that it carried out adequate stress testing of its business model (39). The regulator tried to argue that the responsibility for running a company prudently and designing stress tests lay with the board of the company, but eventually conceded that there had been a failure of its own regulatory stress testing regime with regard to Northern Rock (39). It also conceded that the quality, rigor and intensity of its supervision was insufficient and that it had failed to use the available information on risk to inform its supervisory actions and had not committed adequate resources to the carrying out of its supervisory functions (40). All of this indicates supervisory failure arising from a failure to supervise, and to implement the regulatory objectives, assertively or robustly. The FSA's predilection for a 'light touch' approach to supervision had, in effect, led it to carry out its supervisory functions inadequately.

The FSA's Regulatory Failure in the Regulation of RBS

Another high profile bank that faced severe financial problems during the financial crisis was the Royal Bank of Scotland (RBS). Like Northern Rock, it experienced serious difficulties in obtaining funding from the capital markets. Its funding problems were so severe that the UK government had to inject £45.5 billion of capital into it in order to ensure its survival (41). The problems at RBS arose because it was under-capitalized and did not maintain enough liquidity (41). In addition, it suffered from heavy losses in its credit trading activities and from significant losses realized as a result of its participation in a consortium (along with Fortis and Santander) that acquired ABN AMRO, a Dutch bank (41). Participation in the acquisition of ABN AMRO turned out to be disastrous for RBS because RBS's board and risk committee failed to carry out adequate due diligence before entering into the transaction, while at the same time deciding to finance the acquisition primarily with short-term debt rather than equity (41-42). This was a risky financing strategy, and it reduced RBS's already low capital ratio, thus increasing its funding problems (41). The combination of these factors put RBS in a weak financial position relative to its peers and it subsequently suffered from severe financial problems and had to be bailed out by the UK government.

These factors all arose as a result of decisions made by the senior management (the senior executives and the Board) of RBS. The senior management of RBS had deliberately decided on a policy of being lightly capitalized[i] and relying heavily on short-term funding from the capital markets (41). In addition, their decision to go ahead with the ABN AMRO acquisition on the basis of inadequate due diligence greatly increased the risks and vulnerabilities that RBS faced (41). Such a pattern of poor decisions suggests that there were underlying deficiencies in RBS's management capabilities, governance arrangements, culture and mechanisms for oversight (41). The FSA has highlighted how these poor decisions played a significant role in bringing about RBS's severe financial problems (41). The greed and ineptitude of RBS's senior management were therefore direct causes of the problems that arose at RBS.

The greed and ineptitude of RBS's senior management were not the only causes of its financial problems, and the FSA does share some of the blame for the RBS collapse. The FSA's philosophy and approach to supervision viewed strategy and risk appetite as matters for a firm's board (41). The FSA also succumbed to pressure from the UK government to maintain London's competitive position in financial markets by adopting a 'light touch', hands-off approach to bank supervision (41). This flawed philosophy resulted in the FSA placing undue reliance on assurances from firms' senior managements about governance, strategy, business models and key business decisions (41). This, in effect, amounted to an over-reliance on a system-based form of meta-regulation, thus exposing the FSA to the problems associated with meta-regulation. With regard to its supervision of RBS the FSA's use of systems-based meta-regulation led it to over-rely on RBS's senior management to manage the bank's strategy and risk appetite even when it was clear to the FSA that the bank was taking excessive risks with regard to the growth of its commercial property portfolio (commercial lending activities) and its acquisitions strategy (its participation in the consortium that acquired ABN AMRO) (41).

Application of the theoretical disadvantages of meta-regulation to the Northern Rock and RBS case-studies

The Northern Rock and RBS case-studies highlight a number of problems with meta-regulation, one of which arises from the fact that the regulated firms are prone to making decisions or taking courses of action that undermine the regulator's objectives. The possible divergence of the private interests of the regulated firms from those of the regulator has been a constant cause of regulatory failures in UK financial regulation for example with regard to pensions mis-selling (43) and, more recently, payment protection insurance (PPI) mis-selling (44). This divergence between the private interests of the regulated firms and individuals, on the one hand, and the public interest objectives of the regulator, on the other hand, also played a role in the regulatory failure of the UK financial regulatory regime in the run-up to the financial crisis. Banks and their senior managements used excessively risky business strategies that generated short-term profits for the banks and significant bonuses for their senior managements while at the same time exposing those banks to losses in the long run, and the need for publicly-funded bailouts. The short-term profits and the bankers' bonuses were therefore private incentives that were in direct conflict with the regulator's objectives since they encouraged the banks to adopt excessively risky business strategies which ultimately made the entire financial system much more unstable.

The banks' use of excessively risky business models also exposed the second inherent flaw in meta-regulation- the reliance on firms' systems and processes (which is characteristic of meta-regulation) can expose the regulator to regulatory failure if those firms and their senior managers, who set their systems and processes, are incompetent or inept. This arises because of the relationship between risk and reward, and the effect that this relationship has on how firms and individuals behave within the regulated industry. In entrepreneurship, there is a very close relationship between risk and reward, and as a result of this close relationship the regulated will always be tempted to take on more risk than they can manage. This is because risk has come to be seen as a "condition of opportunity" and an avenue for entrepreneurship and wealth creation (45). It has therefore come to be seen as an integral part of investment activity and as the central cultural framework for financial profit creation in modern society (46). It is therefore an inherent component of wealth creation.

The failure of Northern Rock and the other problems that arose in the financial sector provide a good illustration of the dangers arising from the relationship between risk and reward. In their quest for greater profits the banks underestimated the risks involved in dealing in sub-prime mortgages, over-relied on the capital markets as the primary source of capital, relaxed their credit underwriting standards and used new, but poorly understood technologies, such as CDOs, to diversify their exposures, which in the end became a source of risk themselves (37, 39). Northern Rock, in over-relying on the capital markets as the primary source of its capital, clearly made the mistake of taking on too much risk. The failures to put in place the correct systems and controls to ensure that its risk-taking was not excessive are a management failure by its board which demonstrates its ineptitude. The problem that the ineptitude of the regulated firms poses for meta-regulation arises from the reliance on the regulated to implement the regulation. If the firms and their senior managements are inept then relying on them will lead to problems such as those raised by the failure of Northern Rock. An industry that can miscalculate and underestimate risk on such a large scale, thus undermining the regulatory objectives of maintaining systemic stability, has surely demonstrated that it cannot and should not be entrusted with the responsibility (through meta-regulation) for such an integral part of the regulatory process. To this extent, the Northern Rock failure illustrates one way in which the use of meta-regulation in financial regulation can be problematic.

The failure of RBS also illustrates the dangers arising from a failure to fully appreciate the relationship between risk and reward. The decisions to maintain only a small amount of capital, to over-rely on the capital markets for funding and to enter into the ABN AMRO acquisition based on inadequate due diligence were all decisions that increased the bank's risks without generating any long-lasting rewards for the bank. These decisions highlight the failure of RBS's senior management to put in place effective systems and controls to ensure that its risk-taking was not excessive. They therefore highlight the ineptitude of RBS's senior management in the run-up to, and during, the financial crisis. The FSA's supervision of RBS was deficient because it over-relied on RBS's senior management to put in place effective systems and controls to ensure that its risk-taking was not excessive, and this demonstrates that meta-regulation can be problematic due to the ineptitude of the regulated.

The potential for regulatory inertia is the third inherent problem with meta-regulation. Regulatory inertia played a role in the FSA's supervisory failure in the run-up to the crisis. The FSA, through its 'light touch' approach to supervision, put too much emphasis on market discipline and the ability of the market to correct itself. This resulted in a hands-off approach to supervision which is evidenced by its reluctance and failure to commit adequate resources to carrying out its supervisory functions. It is also evidenced by its preference for looking at firms' systems and controls rather than focusing on their underlying business risks (41). It is also clear that the FSA was confused about the extent of its responsibility for supervising the regulated firms' business models and making sure they put in place effective systems and controls. These are the problems with meta-regulation that can lead to regulatory inertia and can cause the regulator to fail to achieve its objectives.

REGULATORY ENHANCEMENTS AFTER THE GLOBAL FINANCIAL CRISIS

This section will consider the changes that are being made to the UK financial regulation regime in the aftermath of the global financial crisis. This will involve an examination of the FSA's new approach to supervision, which has been referred to as Intensive Supervision, and the extent to which it retains elements of meta-regulation. This section will also include an outline of the new UK coalition government's regulatory reforms for the financial sector, which include an overhaul of the institutional edifice of UK financial regulation and a focus on macro-prudential financial supervision in addition to micro-prudential supervision.

Intensive Supervision

The 'light touch' approach to supervision used by the FSA before the crisis made it reluctant to interfere in how regulated firms conducted their business or to question the judgments of their senior managements. In light of the failure of this approach to supervision the FSA has replaced it with a new approach which has been described as Intensive Supervision. This is a more intrusive and interventionist regulatory style, whereby the regulator is more willing to question the senior managements of the regulated firms on their business models and business strategies, and to compel them to take appropriate remedial actions where their business models or strategies are found to constitute risks to the regulator's objectives (34, 47). This necessarily involves more intrusive inspections and mitigation of risks inherent in the regulated firms' business models (48). The FSA's Supervisory Enhancement Program, which it implemented in 2009, and its Core Prudential

Program, which it implemented in 2010, both illustrate many of the features of this Intensive supervision. These will now be discussed in some detail.

(i) The FSA's Supervisory Enhancement Program (SEP)

As a response to the criticisms of its performance before the onset of the crisis the FSA carried out a review looking into the supervisory failures that contributed to the failure of Northern Rock (40). As a result of the failures it identified the FSA outlined seven high level recommendations designed to improve the quality of its supervision. These are increased engagement of its senior management with high impact firms, increased rigor in its day to day supervision, increased focus on prudential supervision, improvement in its use of information, improvement in the quality and resourcing of its financial and sectoral analysis, strengthening of its supervisory resources and increased involvement of its senior management in the oversight of the regulated firms' supervision (40).

In addition to these seven recommendations the FSA also outlined a comprehensive Supervisory Enhancement Program (SEP), designed to improve its ability to supervise, and to make its supervision more intrusive and intensive. Features of this new SEP include regular review (by specialists) of the supervision of all high-impact firms, increased numbers of supervisory staff for monitoring high-impact firms (with mandated minimum staffing levels in relation to each firm), expansion of the specialist prudential risk department of the FSA, upgrading of the supervisory training and competency framework for FSA staff and increased involvement of FSA senior management in the supervision of high-impact firms (49). Other features include increased focus on liquidity and greater emphasis on assessing the competence of firms' senior management (49). As part of the SEP the FSA will be more proactive in challenging senior managements and boards of firms on the judgments they are making, the consequences of their decisions and their considerations of risks when selecting their business models (50). All in all, this represents a more robust approach to supervision than was the case before the failures of Northern Rock and RBS.

(ii) The FSA's Core Prudential Program (CPP)

The Core Prudential Program (CPP) provides intensive supervision for the largest high impact firms. Its aim is to give supervisors an in-depth understanding of the key risks facing these high impact firms, thus enabling supervisors to put in place appropriate tools for monitoring those risks on an ongoing basis (41). It involves identifying these risks and intervening before they crystallize, and this inevitably means more analysis of the information provided by high impact firms and earlier intervention by the FSA when required, based on in-depth assessments of the firms' businesses (41). It also inevitably means more interference in firms' affairs in order to ensure that they put in place sustainable business models, appropriate risk management frameworks, effective governance mechanisms and sufficient capital and liquidity (41). Like the SEP, this represents a much more robust approach to supervision than was the case before the failures of Northern Rock and RBS.

Merits and Demerits of Intensive Supervision

Intensive supervision offers the potential to significantly reduce or limit the effect of financial crises in the future. By being more willing to critically examine the decisions and business strategies of the regulated firms rather than merely examining their systems and processes the regulator increases its chances of detecting problems with those business decisions and strategies as well as other risks to the regulator's objectives. It therefore puts itself in a better position to take appropriate action to deal with these problems and to mitigate these risks.

This does not, however, mean that Intensive supervision is altogether unproblematic. Intensive supervision raises some issues, one of which is the increase in costs that it could entail- it requires a significant increase in the resources available to the regulator, in order to cover the costs of hiring additional staff and of ensuring that all its staff are properly and adequately trained to carry out their supervisory functions competently (25). Another significant issue that is raised by Intensive supervision is the problem of regulatory arbitrage- in a world where the regulated financial firms can, arguably, move from one jurisdiction to another fairly easily the adoption of an overly strict or onerous approach to regulation can result in the regulated firms moving to other less robustly supervised jurisdictions (51).

Does Intensive Supervision still contain elements of Meta-Regulation or does it represent a move towards Command and Control techniques of Regulation?

The reference to a more intensive and intrusive approach to supervision might give the impression of a move to command and control, prescriptive or more traditional forms of regulation. This is, however, not the case, and it can be argued that Intensive supervision, instead, represents an attempt to improve or strengthen meta-regulation. It is, for example, a supervisory approach that focuses on key business outcomes and the sustainability of the regulated firms' business models and strategies rather than merely focusing on the systems and processes that the regulated firms have in place (25). This greater willingness to examine business models and strategies, and to make judgments on the decisions of firms' senior managements points to a preference for improvements to the regulator's management-based (system-based) approach rather than a wholesale change to command and control regulation.

The FSA itself has expressly stated that it is reluctant to move to a 'bank examiner' approach to supervision, which would move it more in the direction of command and control or prescriptive regulation (25, 47). It is of the belief that the primary responsibility for the individual firm still lies with the firm's management, non-executive directors, shareholders and auditors, and that the regulator should work in partnership with these groups (47). This shows a preference for an improvement to its management-based approach of meta-regulation rather than a move to prescriptive or command and control regulation. The FSA has also signaled that it intends its Intensive supervision approach to be outcomes-focused (48). Outcomes-focused approaches are performance-based in nature and can therefore be viewed as one type of meta-regulation. The FSA's adoption of an outcomes-focused approach again points to a preference for preserving meta-regulation (albeit a more robust form of it) rather than a move to command and control or prescriptive regulation. It is thus clear that Intensive Supervision is meant to be a more robust approach to meta-regulation rather than a move to command and control regulation.

The Coalition Government's proposals

In May 2010 a coalition government was elected into office in the UK, and it has unveiled plans to make some significant changes to the way financial regulation is carried out in the UK. These include changes to the institutional structure of the regulatory regime and changes to the policy focus of the regime. Although the changes have not been fully implemented it is important that they are discussed.

The key institutional change is the transfer of responsibility for prudential regulation (systemic regulation) from the FSA back to the Bank of England.[ii] The prudential regulation of individual financial firms (micro-prudential regulation) will be carried out by a subsidiary of the Bank of England, the Prudential Regulation Authority (PRA), while responsibility for monitoring the financial system as a whole (macro-prudential regulation) will be carried out by a new Financial Policy Committee (FPC), which is to be housed in the Bank of England. The consumer protection function of the FSA will now be carried out by a new Financial Conduct Authority (FCA). The FCA will be in charge of consumer protection and market conduct regulation. The abolition of the FSA and its replacement with these new regulators has, however, drawn some criticisms, for example it has been argued that fixing the FSA, rather than abolishing it, was a solid option (54), and abolishing it and transferring responsibility for micro-prudential supervision back to the Bank of England is unjustified, and entails costs (associated with carrying out such significant institutional change) with no guarantee of success since policies and people are likely to be more important factors (in determining whether or not the regime succeeds) than institutional structure (51). This is all the more the case if we take into account the fact that the FSA had already acknowledged its mistakes and was taking steps to rectify them (25, 49). Moreover the coalition government's proposed statutory objectives for the new regulators (especially the PRA and the FCA), and the regulatory principles governing how the regulators should carry out their functions, appear to be strikingly similar to those of the FSA (55).

The key policy change is an increased focus on risks to the overall financial system as a whole (macro-prudential regulation) in addition to micro-prudential regulation. In order to address macro-prudential regulation the FPC, situated within the Bank of England, is tasked with protecting the stability of the financial system as a whole, by identifying risks to the financial system's stability and intervening to ensure appropriate action is taken, where needed, to ensure stability (55-56). The belief is that having this committee dedicated to macro-prudential regulation and housed within the Bank of England will ensure that macro-prudential issues are properly dealt with and that there will be more clarity on who is responsible for dealing with it.

The Coalition Government's Plans and how they tie in with Meta-Regulation

One implication of overhauling the institutional framework of UK financial regulation and replacing the FSA with multiple regulators is the potential for multiple supervisory approaches since each regulator can decide to adopt a different approach from the others. The PRA and FCA are the regulators of individual firms and therefore their approaches should be examined in the context of a discussion on the appropriateness of meta-regulation as a supervisory approach. It is difficult to make a definitive determination of what type of approach each will adopt since the regulators themselves have not yet fully come into existence. It is, however, possible to make some tentative observations based on the consultations and policy papers that have recently been published by the coalition government.

The PRA will, apparently, adopt a ‘judgment-led’ approach to supervision, whereby the nature and intensity of supervision will depend on the risks posed by each firm (55-56). It will draw on its analyses as part of its “proactive approach to identifying weaknesses within firms” and intervening to require them to address those weaknesses (55). With regard to approval for authorization to carry on financial business, for example, the PRA will be concerned to ensure that, after authorization, the firm will be prudently managed and will have a viable business model (55). This indicates the retention of a risk-based approach to regulation in conjunction with an effort to make sure that management-based supervision is improved. It therefore suggests that meta-regulation will be retained, albeit with an attempt to improve it by making it more rigorous. In addition, the PRA’s approach is expected to “seek to go beyond monitoring ‘tick-box’ compliance with rules” (55) and to “make greater use of principles in implementing its approach” and to use a purposive application of the rules in order to ensure “compliance with the ‘spirit’ as well as the letter of the rules” (55). This purposive approach suggests a performance-based approach to supervision, and therefore the retention of meta-regulation. The PRA’s approach does not, on the face of it, appear to be radically different from the FSA’s proposals for improving its supervision through intensive supervision, and this, perhaps, supports the argument that the FSA could have been ‘repaired’ and that replacing it is an unnecessary and costly exercise.

The FCA will also adopt a judgment-led approach to supervision, whereby it will be looking to identify potential causes of consumer detriment at an early stage and to take action to address them (55). This has apparently been described as “a more proactive, interventionist approach” (55). Although regulated firms will be supervised on an individual basis, the FCA will also intervene where it is clear that an issue affects a whole sector, sub-sector or type of product (55). This is suggestive of a more robust or intensive approach to supervision. Despite this movement to a more intensive approach it appears the FCA will retain meta-regulation- the coalition government insists that the FCA will not adopt a pre-approval regime for financial products (55). In addition, the coalition government firmly believes that the senior managements of firms should remain responsible for ensuring that their firms are in compliance with the requirements of the regulatory regime (55). This again suggests the retention of meta-regulation, albeit a more robust, intrusive form of it.

CONCLUSION

This article has examined meta-regulation and has identified some of the benefits and problems associated with it. The article has used the supervision of both Northern Rock and RBS in the run-up to the global financial crisis as case-studies on the use of meta-regulation in the regulation of financial firms in the UK. In so doing, it has highlighted how the problems associated with meta-regulation can lead to serious regulatory failures. The high hopes that meta-regulation would help regulators to achieve more, even though they were devoting fewer resources and less effort to their regulatory tasks, have not fully materialized, particularly in the case of UK financial regulation. Instead it appears that regulators will now have to expend more resources and increase their efforts with regard to their regulatory tasks, for example both the FSA's Intensive Supervision and the coalition government's regulatory changes will necessarily entail a greater willingness to examine the regulated firms' business models and strategies and to make judgments on the decisions of their senior managements.

Interestingly, meta-regulation, although problematic, appears likely to remain a key part of the supervisory approach in UK financial regulation. The more intrusive approach to supervision that has been proposed by both the FSA and the new coalition government retains key characteristics of meta-regulation. The proposed reforms could go some way toward improving meta-regulation but this does not mean that the problems associated with meta-regulation will go away altogether. Although intrusive supervision might go some way towards addressing the problems of regulatory inertia, regulatory capture and the possible ineptitude of the regulated, the problem of how to better align the private interests of the regulated with the public interest objective of the regulator will continue to be a key challenge.

The continued preference for meta-regulation reflects the fact that it is very much liked by regulators and policy makers. This is not just because of the strengths of meta-regulation that have been outlined in this article, but also because devolving responsibility, for the regulatory process, to the regulated also means, in reality, devolving a certain level of accountability to them. The FSA failed to convincingly shift its accountability for the regulatory regime to the regulated and was ultimately held accountable for its regulatory failures. This will not be the case with every regulatory regime, however, and being able to shift accountability, and therefore culpability, for regulatory failures is something that policymakers and regulators would like to be able to do. In a world where the pressures on regulators have increased and a lot is demanded from them they are bound to find regulatory approaches which allow them to devolve responsibility, accountability and culpability for regulatory failures, unto others, very appealing, and this, to an extent, provides an explanation of the continued preference for meta-regulation.

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[i] In the former RBS CEO's words, they had adopted a policy of "capital efficiency"- see Full Year 2005 RBS earnings conference call, 28 February 2006, Transcripts sourced from Thomson StreetEvents

[ii] The Bank of England was in charge of prudential regulation of UK banks before 1998. Ironically, this responsibility for bank regulation was transferred away from the Bank of England largely as a result of its own regulatory failures- see 52. Hall MJB. Handbook of Banking Regulation and Supervision in the UK. Third Edition ed. Cheltenham: Edward Elgar; 1999, 53. Ferran E. Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model. Brooklyn Journal of International Law. 2002;28(2):257-307.