

# A financial regulatory regime reform template to ensure financial stability for the Chinese economy

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## Important Abbreviations

**HMT** – Her Majesty's Treasury, the UK's finance and economy ministry

**BoE** – Bank of England

**FSA** – Financial Services Authority (until 2012)

**FCA** – Financial Conduct Authority

**PRA** – Prudential Regulation Authority

**PRC** – Prudential Regulation Committee

**FPC** – Financial Policy Committee

**PBoC** – People's Bank of China

**FSDC** – Financial Stability and Development Committee

**CBRC** – China Banking Regulatory Commission

**CIRC** – China Insurance Regulatory Commission

**CBIRC** – China Banking and Insurance Regulatory Commission

**CSRC** – China Securities Regulatory Commission

**NBFI** – Non Bank Financial Institutions

**NPL** – Non Performing Loans

**SOE** – State-owned Enterprise

**IMF** – International Monetary Fund

**FSAP** – Financial Sector Assessment Programme (of the IMF)

**IOSCO** – International Organisation of Securities Commissions



# Contents

|  |           |
|--|-----------|
| <b>Executive Summary</b>   | <b>2</b>  |
| <b>1. Introduction</b>   | <b>4</b>  |
| Regulatory objectives in the UK and China  | 5         |
| Market integrity and consumer protection   | 5         |
| Support of real economy  | 6         |
| Prevention of systemic risk  | 6         |
| Structure of this report   | 7         |
| Background of this report  | 7         |
| Acknowledgments  | 7         |
| <b>2. The UK Model – Regulating and Supervising the World’s Leading Financial Market Place</b>         | <b>8</b>  |
| Institutional Framework  | 8         |
| Background: available supervisory models   | 9         |
| – Functional model   | 9         |
| – Institutional model  | 9         |
| – Integrated model   | 11        |
| – Twin peaks   | 12        |
| – Excuse: The Central Bank as Supervisor   | 13        |
| UK: ‘Twin Peaks Plus’  | 14        |
| – Bank of England (BoE)  | 14        |
| – Financial Policy Committee (FPC)   | 14        |
| – Monetary Policy Committee (MPC)  | 15        |
| – Prudential Regulation Authority (PRA)  | 15        |
| – Financial Conduct Authority (FCA)  | 16        |
| Regulatory perimeter of the FCA  | 16        |
| Regulatory framework   | 16        |
| FCA’s role in financial innovation   | 17        |
| – Treasury   | 17        |
| – Co-ordination of policies  | 18        |
| Fiscal and monetary policy (Treasury-Bank of England)  | 18        |
| Monetary policy and financial stability (MPC-FPC)  | 19        |
| Conduct and prudential supervision (FCA–PRA)   | 20        |
| – Supervisory Strategy: Risk and Principles-based  | 21        |
| <b>3. China’s system of financial regulations: challenges</b>  | <b>23</b> |
| Potential conflicts between policies that promote economic growth and that enforce financial stability | 24        |
| Complex and Inter-Connected Financial Systems and Systemic Risk Assessment                             | 24        |
| Regulatory Vacuum and Overlap  | 26        |
| Regulatory Coordination  | 29        |
| <b>4. Practical Recommendations for China</b>  | <b>30</b> |
| Structural differences   | 30        |
| Differences as to regulatory objectives  | 33        |
| Recommendations  | 34        |
| FPC – A Blueprint for FSDC with Chinese Characteristics  | 34        |
| Coordinating: Three Levels of Coordination   | 36        |
| Balancing Growth, Innovation and stability: Learn from FCA’s Innovation Hub                            | 37        |
| Revenues and Resources   | 39        |
| <b>5. Conclusion and outlook</b>   | <b>40</b> |

## Executive Summary

In this report, we share the United Kingdom's experience in developing its financial regulatory regime for one of the world's largest, most sophisticated, and interlinked financial systems in the hope of engaging in a productive debate on how to reform China's financial regulatory regime. The existing regulatory system was set up more than a decade ago and the financial industry has gone through dramatic changes during this time. The question of how to regulate this growing financial system in order to achieve efficiency, fairness and competitiveness as well as promote growth and ensure stability has become an urgent issue.

In the aftermath of the global financial crisis of 2008, the United Kingdom has adopted some elements of "twin-peak" regulatory architecture such as prudential (PRA) and conduct regulators (FCA), but also involves a "topping" which is the Financial Policy Committee (FPC), a macro prudential regulator, and many "underwood" including the Treasury, and others. The Bank of England (BoE) plays an important role since both PRA and FPC are located inside the BoE. Unlike the rule-based regulatory system as found in the United States of America, the UK regulatory system is risk and principles-based and flexible in adopting to changing financial systems. Policy objectives are clearly delineated for all parties involved with accountability. There is a reasonably well-managed coordination process among monetary, fiscal and financial policy making bodies to ensure an effective institutional and governance structure to implement policies. Although the design of the UK's institutional structure deserves attention, the more important element of the UK approach is its risk-based and principle-based regulatory and supervisory style. It sets the UK regulatory system apart from others and makes it practical, flexible and adaptable to the changing environment. Based on these general observations, our broad recommendations for reforming China's existing regulatory system are

- 1) to adopt a somewhat similar risk-based and principles-based regulatory system, with Chinese characteristics, that very importantly remains flexible to new technologies and challenges; and**
- 2) to utilise the existing regulatory framework and achieve its maximal ability to regulate the growing financial system by designing a better coordination mechanism.**

In addition, in the report, we suggest practical and implementable policy changes to ensure the following three points:

- 1) that the fundamental prudential objectives are achieved;**
- 2) coordination among various regulatory agencies is maintained; and**
- 3) that the objective of high quality growth (but not growth at any price) is not compromised.**

**For point 1**, we recommend the newly created Chinese Financial Stability and Development Committee (FSDC) under the State Council to adopt similar mandates and powers of the FPC in the UK but with Chinese characteristics.

Specifically, it should have a primary objective in enhancing the resilience of the Chinese financial system and a secondary objective of supporting high quality growth in the economy. It should be mandated with hard powers of direction and of recommendation with formal comply or explain authority. It can set regulatory perimeters and designate systemically important institutions in the economy. Furthermore, the FSDC can make recommendations to nonfinancial as well as financial sectors, to the extent that practices could lead to increases in macrofinancial imbalances and systemic risk. *This unique feature in the Chinese financial regulatory regimes potentially pioneers a new approach to address financial stability in all rapidly growing transition economies.*

It needs to increase its capacity to identify, monitor and assess systemic risk by establishing a research department focusing on important systemic issues. It should have a strong role in coordinating between multiple sector regulators, together with the People's Bank of China (PBoC). Governing boards for regulators should have cross-over membership.

As an example of how the FSDC committee might be structured: it could be chaired by a standing member of the Politburo and the PBoC governor also plays an important role. Its member of the Politburo and the PBoC governor, and its members could include deputy governors of the PBoC that are responsible for exchange rates policy and financial stability, as well as the newly merged banking and insurance regulator CBIRC, CSRC, the Ministry of Finance, and external members.

MoUs for cooperation between all Chinese regulators should be established and meetings should be scheduled at least quarterly among director-level officials across all regulatory agencies and PBoC should be established. This is to ensure communication and negotiation channels are continuously open.

**For point 2**, we recommend coordination enforcement at three levels based on the UK coordination mechanisms:

- 1) the FSDC should be the main regulatory body to implement and oversee the highest level of coordination across PBoC, CBIRC, and CSRC;
- 2) coordination protocols and mechanisms among policy and supervision teams among PBoC, CBIRC, and CSRC when implementing new policy rules and enforcing regulatory penalties should be established formally; and
- 3) a research hub coordinating information sharing and analysis among regulators in China should be established.

**For point 3**, we recommend learning from FCA's Innovation Hub in Balancing Growth, Innovation and Stability:

- 1) creating a similar regulatory initiative to FCA's Innovation Hub;
- 2) to set up a regulatory sandbox to facilitate financial product and service innovations;
- 3) to create a market research institute/facility under the PBoC and all of the functional regulatory commissions, with a research hub coordinating the effort, and
- 4) active cooperation with international regulatory bodies and prominent academic institutions.

We also recommend Chinese supervisors defining their supervisory style in a way similar to the UK, notably focused on risk and outcome.

Finally, we recommend Chinese regulators (CBRC, CIRC, CSRC) consider following the fee-based revenue model of FCA to increase their budget autonomy in line with the growing financial industries. We also recommend a substantial research department in addition to the policy and supervision departments to be established under each regulator.



# 1.

## Introduction

This report is part of the UK-China Financial Policy Initiative and is designed to promote mutual understanding of China's and the UK's financial regulatory and supervisory systems and beyond. The ultimate goal is to further co-operation and support cross-jurisdictional investment, on the basis of enhanced efficiency and a higher degree of sustainability, to the benefit of investors, businesses and customers in both countries.

The UK's model of regulation and supervision of the financial market has been successfully modernised since the 2008-2010 financial crisis. In particular, the introduction of specific macro-prudential oversight in addition to micro- and conduct supervision ('twin peaks') has proved as so far effective but yet to be tested in a crisis.

The analysis underlying these reforms may be instrumental in the context of similar future reforms in the PRC. The IMF's 2017 Financial Sector Assessment Program report (FSAP) on China has identified a number of challenges faced by the Chinese financial system. Essentially, for a transitional economy such as China, there are inherent distortions in the real economy to ensure stability in society such as distortions in the product market competition, factor (labour, land, etc) costs, energy, and other resources prices and the environment.<sup>1</sup>

This leads to distortions in financial system (such as distorted capital costs, bailouts, unrealistic expectations of risk-return tradeoffs) to feedback into the distortions in economic growth. For a long time, Chinese economic reform has been focusing on the real economy rather than the financial system. This feedback loop has been growing with the financial system and threatens financial stability. The challenge is how to break this potentially vicious cycle to enhance stability for both the financial system and the real economy. The regulatory and supervision system could play a major role. The issue is particularly acute since China's importance as a financial market place

has grown exponentially, now with financial assets at nearly 470 percent of gross domestic product.

The Chinese government has realised this urgency and quickened the reform activities across the economic sectors. The Financial Stability and Development Committee (FSDC) was established in 2017 tasked with duties of strengthening the central bank's macro-prudential regulations and the prevention of systemic risk.<sup>2</sup> In March 2018 during the People's Congress, an overhaul of the regulatory system was announced. This includes the merger of banking and insurance regulators and giving new powers to policymakers such as the central banks. A national markets supervision management bureau will also be formed to tackle some of the distortions in the real sectors. This flurry of reforming activities provides a chance to benefit from these UK experiences gained during the last reform process.

<sup>1</sup> See Huang and Wang (2010, *China & World Economy*, 18(4), pp.1-17) for detailed descriptions of some of these real distortions. An example given is the setting of domestic oil prices. The National Development and Reform Commission (NDRC) adopted a formula linking domestic oil prices with several international prices. Whenever international prices moved by more than 7 percent, domestic prices would be adjusted accordingly. However, when international crude prices moved to above US\$80 per barrel, the NDRC stopped adjusting domestic prices for fear of higher prices disrupting production and consumption.

<sup>2</sup> *China Banking News*, November 9, 2017, China's Financial Stability and Development Committee Officially Launches.

## REGULATORY OBJECTIVES IN THE UK AND CHINA

Societies take issue with freely exercised businesses where there is a risk of market failure, ie., that the common good is at risk, such as on the grounds of security, public health or the possibility of a negative effect on the state's economic development and social cohesion. More concretely, the relevant rationales on which state regulation of financial business is typically based can be subdivided into (a) market integrity; (b) support of the real economy; (c) protection against systemic risk, and (d) competition. Other categorisations are possible.<sup>3</sup>

These rationales are intertwined and partly antagonistic, and may be given different relative weights in different jurisdictions.<sup>4</sup> They may also change over time. In the UK, as in many other jurisdictions, protection against systemic risk has moved to the forefront since the beginning of the 2008 Financial Crisis – before that, market integrity was seen as the most important regulatory objective. In China, until now, support of the real economy and political stability were the major drivers of financial regulation, whereas now protection against systemic risk and financial stability move, step by step, more into the focus.

Speaking more generally, there are significant differences between both countries with regard to the importance of financial regulation as a means of supporting the economic policies of the government.

## Market integrity and consumer protection

Measures promoting market integrity employ mechanisms to establish 'fairness' and 'confidence in the market.' However, in principle, every market participant is allowed to use the best of its abilities to make profit. There is no general protection of the other party against loss. Still, a functioning market needs a broad investor base to ensure sufficient liquidity and depth of the market. Investors will only invest into a market if they feel assured of being treated correctly (which does not mean being protected against their own, potentially erroneous, investment decisions). To this end, regulators impose a variety of duties and prohibitions on market participants to remove, for example, unfair advantages from information asymmetries, in order to keep the market trustworthy. The most striking example of the distortive effect of information asymmetries is the so-called principal-agent problem. Rules addressing the principal-agent problem and information asymmetries in general function on the basis of (1) a duty to inform clients, (2) documentation of how decisions were made, (3) duties to follow the option which is in the client's best interest, and (4) documentation of results and alternative results.

In principle, these matters apply to both the wholesale and retail ('consumer') sphere. However, the 'fairness' argument is relevant to a different extent depending on who is contracting: where banks deal with consumers the required levels of 'fairness' are highest. At the other end of the scale are transactions amongst equals, e.g. amongst two sophisticated parties such as banks, where lower fairness requirements apply. To this end, regulation typically classifies market participants into three or four categories (e.g., into natural persons (consumers), corporations generally, and financial institutions), entailing different levels of protection.

<sup>3</sup> See, for example, Armour et al., pp. 61-72: (a) protection of investors and other users of the financial system; (b) consumer protection; (c) financial stability; (d) market efficiency; (e) competition; (d) prevention of financial crime.

<sup>4</sup> A lot of the literature on competition versus stability in banking suggests that a more competitive system is also more stable.



## Support of real economy

In China and other countries, regulation may also be used to counter distortions in the real economy, support growth and political stability. At the same time, measures focused on these effects may create long-term opposite effects in other areas. For example, growth of the real economy has been the main objective for emerging and transitional markets and sometimes this has been at the expense of market integrity and financial stability.

Typically, fairness and prudential considerations start to come to attention when the economic development achieves certain level. This may well be the case in China which is currently shifting its focus more to financial stability and systemic risk, as manifested by the recent creation of the Financial Stability and Development Committee (FSDC).

## Prevention of systemic risk

Until the 2008 Financial Crisis, systemic risk prevention as a separate area of regulation did not figure prominently on the agenda in any part of the developed international financial market. It was assumed that the stability of the system as a whole was sufficiently addressed by guaranteeing the stability of market participants themselves (micro-prudential regulation) and by pursuing a moderating monetary policy, thereby preventing an overheating of the market. Deposit insurance was the only salient early measure aimed at protecting the system as a whole against systemic effects. However, the recent financial crisis has proven that the combination of micro-prudential regulation, monetary policy and deposit insurance is insufficient to protect the financial market against systemic risk.

As a result, the system to prevent the building up of systemic risk consists nowadays of micro- and macro-prudential measures, alongside monetary policy. Systemic risk prevention has been at the centre of reform since the last financial crisis, first in terms of introducing new or strengthened material rules, notably measures regarding capital and liquidity, bank resolution and structural reform, central clearing, or credit ratings. In addition, dedicated supervisory structures and processes have been built, nationally and internationally, at various levels. For instance, in the UK, the PRA was created and given a robust mandate which reflects the importance now attributed to systemic stability. In the same vein, China recently created the FSDC.

## STRUCTURE OF THIS REPORT

The UK's regulatory and supervisory model is presented in Chapter 2, with a special emphasis on the functioning and role of the Prudential Regulation Authority (PRA) and of the Financial Policy Committee (FPC). Special regard will be given to their remit and to how their policies are co-ordinated with other regulatory, supervisory and governmental bodies, in particular the Financial Conduct Authority (FCA), the Treasury and the Bank of England (BoE). To provide the complete view, the UK's model is contrasted by models successfully used in other financial markets, such as the US, Germany, France, Australia, and the EU.

**Chapter 3** sets out the current challenges for the regulatory and supervisory system in China, notably referring to:

- The potential conflict between policies promoting economic growth and the objective of financial stability;
- The complexity of inter-connected financial systems and, accordingly, the difficulty to assess the inherent risk;
- Regulatory vacuum and overlap; and,
- The difficulties of regulatory coordination.

In **Chapter 4**, the authors formulate a number of policies that could benefit the future development of the Chinese regulatory and supervisory set up. These recommendations relate to:

- The set-up of the new Chinese FSDC on terms similar to those of the FPC;
- Co-ordination between regulators on rule making, rule enforcement and research;
- A balanced approach to prioritising regulatory objectives, notably in relation to stability and growth objectives;
- The development and communication of clear, risk and principles-based supervisory style; and,
- The staff and resources necessary to regulate and supervise a fast-growing financial market.

## BACKGROUND OF THIS REPORT

This report has been commissioned by the UK's Foreign and Commonwealth Office. It has been prepared by a group of academics drawn from the London School of Economics and Political Science and PBC School of Finance at Tsinghua University.

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## 2. The UK Model – Regulating and Supervising the World’s Leading Financial Market Place

### INSTITUTIONAL FRAMEWORK

In 1997 the UK created a unified regulator – the Financial Services Authority (FSA), which supervised almost all financial firms in the UK on a “conduct” and “safety and soundness” (i.e., micro-prudential) basis. This move to an ‘integrated’ approach was motivated by major financial firms developing full service businesses in the UK in the 1990s – which made the former approach of supervising different institutions by different regulators unworkable. The four main statutory objectives of the FSA were to maintain market confidence, promote public awareness, protect consumers, and reduce financial crime. The few major aspects outside the FSA’s approach were corporate reporting and governance – for which the Financial Reporting Council was responsible, with the Takeover Panel having responsibilities around M&A transactions, and Consumer Credit which was regulated by the Office of Fair Trading and not the FCA.

When the reforms took place in 1997, the BoE was made independent as regards its monetary policy – but at the same time stripped of its direct supervisory role, so as not to “unduly concentrate power” in it. It still gathered market intelligence and oversaw the payment system.

The events culminating in the run on Northern Rock in September 2007 prompted criticism of the integrated approach and a review of the integrated system, but it was generally affirmed by the government, although some changes were proposed (including regarding deposit insurance), and roles of the “Tripartite Authorities” (Treasury, BoE and FSA) were clarified. The FSA had broad investigatory, enforcement and prosecutorial powers. It was generally regarded as a “model regulator” in terms of efficiency and effectiveness and was described as such in the G30 report of 2008.

In 2010, the government gave the FSA a new legislative mandate (which was ultimately solidified in legislation in 2012), after the new coalition Conservative-Liberal Democrat government had formed. On that basis, prudential supervision was moved back to the BoE, and conducted by its subsidiary, the Prudential Regulation Authority (PRA). It was given regulatory responsibilities for clearing houses and payment systems (though subsequently responsibilities for payment systems were given to Financial Conduct Authority (FCA)).

Responsibility for macro-prudential supervision was afforded to the Financial Policy Committee (FPC). The FSA was renamed the FCA, and otherwise largely kept its mandate, and was also given a competition objective and responsibility for consumer credit.

Thus, as a consequence of the financial crisis, in 2012, the UK fundamentally reorganised financial regulation and supervision. Perceived public opinion was that the Integrated Approach supervisory system had failed – and a decisive response was required. This led to the UK shift from an integrated to twin peaks model. “Domestic politics played a significant factor in shaping the nature and extent of this exercise”.

Micro-prudential regulation was vested in the PRA which is part of, but operationally independent from, the BoE. The FCA was created as a limited company. Within the BoE is a systemic oversight body and a dedicated function for resolution were created. PRA and FCA both issued positioning statements in 2012, setting out their new regulatory approaches. The new regime was heavily influenced by the FSA and Bank officials, however. It is therefore no surprise that “the approaches they adopted in their first year of operation thus had their roots in decisions made while neither formally existed and the FSA was still the regulator” (Black).

As Ferran notes, the structures in each jurisdiction are reflective of many influences – including politics, size, history, business models, as well as other factors. As a result, some models will be more effective in one jurisdiction than another. The natural corollary of this is that one model could not be applied across all jurisdictions (if we took a fresh slate to regulation) to achieve a universally “best” result in terms of efficiency and effectiveness.



## Background: available supervisory models

There are four basic models: Functional, Institutional, Integrated and Twin Peaks.

### Functional model

In this model, regulation of business depends on the **type of business conducted** by the firm. Supervisory oversight is determined by the type of business that is being transacted by the entity, without regard to its legal status. Each type of business may have its own functional regulator, so if a firm carries on different types of business, it may be answerable to different regulators regarding each business. Under the institutional approach, the regulator would be responsible for both safety and soundness of the business, and business conduct regulation. This approach remains common, and is supposed to work well as long as coordination between agencies is done efficiently. A single, technically expert regulator can consistently apply rules to the same activity regardless of the entity. This is intended to ensure fairness and avoid regulatory arbitrage.

It is recognised as suboptimal, however, and many jurisdictions seem to be moving away from it toward integrated or twin peaks approaches. Reasons for this include (but are not limited to) difficulty in distinguishing which activity should fall under which regulator; the potential for inconsistency of different agencies to assert authority over the same activity; reluctance of regulators to allow other agencies authority over their expanding activities (further, if regulators compete for jurisdiction the motivations for regulation will be tarnished – especially if regulators are funded by entities they regulate this could create a ‘race to the bottom’) and jurisdictional uncertainty, which could drive business offshore. The model requires firms to deal with multiple regulators, which can be more expensive and more cumbersome in terms of reporting time and energy, as well as extensive coordination between regulators to prevent overlaps and ensure there are no gaps. As with the institutional model, no single regulator would have an overview of information for all the activities of an entity it regulates, so would be unable to assess systemic risk. Indeed, under this model it may be the case that no regulator could monitor for systemic risk.

### Institutional model

Regulation depends on a **firm’s legal status**. A particular firm’s legal status (for example, a bank, broker-dealer, or insurance company) determines which regulator is tasked with overseeing its activity, from both a safety and soundness and a business conduct perspective.

This approach to regulation is based on a business model of institutions providing services within a particular “sector”; a model which no longer exists in practice. Large financial firms now provide a wide suite of products; markets generally no longer have monoline activity based firms anymore.

In practice, a business will operate in accordance with its business line, not its legal status, which can create enforcement difficulties if it ‘branches’ out to provide a new service. If a business was forced to operate on the basis of its legal status for regulatory purposes, this could arguably inhibit expansion of businesses for fear of regulatory confusion or implications. This model also gives rise to a distinct possibility for inconsistency in the application of rules and regulations by disparate regulators, and could see the same activity, conducted by different entities, regulated differently – allowing regulatory arbitrage to occur. The blurred sectorial nature of financial services provided by regulated firms will only increase, and regulation will therefore become even more difficult, as financial services firms and products continue to evolve beyond their institutional labels.

The model also has potentially concerning regulatory implications. If a regulator expanded its scope it would likely overlap with another, and if two regulators attempt to regulate the same entity they will need to ensure they coordinate to do so consistently. As above, without a single regulator with an overview of the entire market, there is arguably no one in the system with the ability to make informed and efficient changes and take actions to mitigate systemic risk. Aside from simply failing to detect systemic risk, disparate regulators may have a harder time working to prevent it, and could even exaggerate it.

The insitutional model is often regarded as too inflexible – as markets everywhere innovate (new products emerge, activities and organisational structures emerge) – and the sectoral boundaries break down. As a result,



### Jurisdictions using the functional model of supervision

US regulation is heavily influenced by the country's history, politics and culture. The structure is quite complex and "can be best described as a functional approach, with some institutional elements" (G20 report, pg. 32). One unique aspect is its dual nature – with banks having the choice of state or federal charters. Banking and securities activities are regulated at state and federal levels by multiple regulators, while insurance is regulated at state level and futures are principally regulated at federal level. There have been studies highlighting the potential negative effects for competition of the dual system. Note: New FSOC (see below) Supervision in the US is divided between a number of authorities: Securities & Exchange Commission (SEC); Commodity Futures Trading Commission (CFTC); Federal Reserve System ("Fed"); Federal Deposit Insurance Corporation (FDIC); Financial Crimes Enforcement Network (FinCEN); Financial Industry Regulatory Authority (FINRA); Office of the Comptroller of the Currency (OCC); National Credit Union Administration (NCUA); Consumer Financial Protection Bureau (CFPB); National Association of Insurance Commissioners (NAIC); National Futures Association (NFA); In addition, each state has its own banking authority.

**Brazil's** regulatory structure could be characterised as a functional system with some institutional elements. It consists of four specific regulators: CVM (the securities regulator), the Central Bank (responsible for prudential and financial institution supervision), SUSEP (the insurance regulator) and PREVIC (pensions). Coordination between these is promoted by COREMEC – a committee established for this purpose in 2008. The shape that the regulatory system has developed is due to various influences within Brazil itself. After the Government's implementation of a macro-economic stabilisation plan, the "Government Plan for Economic Action", the need for reorganisation of the financial

system was recognised. The "National Financial System Law" of 1964 was passed, and today remains the principal legislation underpinning the Brazilian financial markets. The Act establishes the National Monetary Council (which includes the Minister of Finance, Minister of Planning and Governor of the Central Bank), and the Brazilian Central Bank (an independent federal institution that became the monetary authority). The Brazilian Central Bank (BCB) took over the monetary authority functions – but the BCB was not given full authority and responsibilities of a central bank. The BCB became the currency issuing bank, and was the government's financial agent in charge of managing federal public debt, but the Bank of Brazil still retained some central bank like functions. In 1985 the financial supervisory structure was again rearranged and the overlapping functions of the BCB and Bank of Brazil were removed. During 1988 full monetary authority was progressively transferred from the Bank of Brazil to the BCB. In the 1990s Brazil suffered a series of bank failures, and by the mid-90s inflation rates rose to almost 46%. In 1995 the BCB intervened in one particularly large bank. To address the crisis the Government announced a commitment to bear the costs of losses in place of banks' creditors to encourage mergers and acquisitions of the banks facing difficulties. The Government also enacted prudential regulation and strengthened supervision to ensure safety and soundness. In April 2002 the Brazilian Payment System was reformed – so that the BCB would not accept any negative balances on reserve accounts of any bank.

### **Jurisdictions using the institutional model of supervision**

**China** operates on the basis of a primarily institutional structure – though with some functional elements. Over the 25 years preceding the report, the authors note that China is one of the (relatively few) jurisdictions that has not moved towards an integrated or twin peaks approach. Initially, all financial supervision was done through the PBoC. Now however, it has been allocated within other institutions:

- China Securities Regulatory Commission (CSRC) is an agency supervising and regulating securities and futures (since 1998).
- China Insurance Regulatory Commission (CIRC) oversees insurance industry since 1998 and is merged with CBRC to form CBIRC.
- China Banking Regulatory Commission (CBRC) is responsible for banking sector since 2003 and is merged with CIRC to form CBIRC.
- PBoC's role is limited – now simply formulates (and has significant influence via the Governor of the Bank who is a member of the State Council of China – so has influence over financial reforms) and implements monetary policy to maintain financial stability.

supervision aligned on traditional lines can lead to gaps and inconsistent supervision. This can also mean that not enough focus is put on stability and soundness risks, which requires a holistic view. As a result, many jurisdictions have moved away from this model since the 1980s as financial sectors grew and globalised (these included Singapore, Norway, Sweden, Denmark, the UK, Germany, Australia, South Korea and Japan). In practice, it can be difficult to determine whether a jurisdiction is operating under an institutional or a functional approach, especially where an institution is permitted by regulators to “expand into new business lines within an existing entity”. Sometimes the terms are used interchangeably.

### **Integrated model**

The integrated model was popular in the 1990s and 2000s, however there are now concerns about its appropriateness, not least because it was “tarnished” by the perceived failure of the UK Financial Services Authority (UK-FSA) to predict and prevent impacts of the 2008-2010 financial crisis.

Regardless of the firm's business or its legal status, **a single universal regulator** conducts both safety and soundness oversight and conduct-of-business regulation **for all the sectors** of financial services business. It enables a streamlined focus on regulation and supervision, without confusion or conflict over jurisdiction “territories” as under the institutional and functional models. The clarity of focus arguably leads to higher-quality regulation. Also, it allows for a “panoramic” view of an entity's business – which is both broad and deep - and allows for control of issues by timely response to changes. It is more cost-effective for entities to report to a single regulator and ensures consistent application of rules. It has also been adopted in larger markets also where it still has the advantage of being a streamlined approach, and can give a unified focus on supervision without worrying about confusion or conflict of scope – which can plague the institutional and functional approaches.

The key disadvantage is that inherently it gives rise to an elevated risk of a single point of failure. In particular, the integrated model may put too high a burden on a single authority in a large market, making it difficult to govern and potentially creating inefficiencies and conflict of



### Jurisdictions using the institutional supervisory model

**Germany's BaFin** is an integrated regulator, but the Bundesbank continues to play a role in banking supervision. This has led to overlaps and duplications in audits. It is likely, however, that this could be managed by effective coordination efforts – unless there is a genuine dispute where one regulatory refuses to give up scope in favour of the other.

interests. The model is generally unsuitable except in small countries where “gains from economies of scale may be significant”. Further, the regulator tends to focus on some areas, meaning others are ignored (e.g. the UK-FSA who concentrate attention too much on consumer protection at the expense of other areas, including systemic risk). Furthermore, where it sidelines central banks in financial supervision this model does not take into account the interconnection between monetary policy and financial stability, and the central banks role as lender of last resort. At the same time, the association of an integrated agency with the central bank causes a risk of conflict of interest (see below). It may also be difficult to ensure that there are appropriate checks and balances on a single regulator. A regulator could become too large to be effective across the entire market if it regulates a large market, and would have to divide its workflows into “manageable business units”. As a result, communication difficulties could arise across the regulator as a whole, without sound information sharing policies in place. If the business workflows are divided, the advantages of a single regulator are lost and each unit may as well be a different regulator if a robust communications policy is not sufficiently in place. A single regulator has the potential to become a monopolistic bureaucracy with all its inefficiencies.

In the UK the former FSA, in reflecting on lessons learned in the Northern Rock run, pointed to internal reorganisations that meant responsibility for Northern Rock fitted under three different departments in three years. It also cited a demanding workload and strained resources, as well as breakdowns in information and intelligence flows – internally and externally.

### Twin peaks

The twin peaks model is “now in the ascendancy in policy circles”. It can allow more focus on different regulatory objectives. Regulation is done **between two “peaks”** who each have separate regulatory functions: one that performs the **safety and soundness** supervision function and the other that focuses on **conduct-of-business** regulation. There is usually also a split between wholesale/retail regulation under the conduct-of-business regulator.

This model can achieve the benefits of the integrated approach while avoiding the risk of a single point of failure. It can also address the “inherent conflicts” that may arise between safety and soundness, and consumer protection and transparency. It is designed to have the benefits and efficiencies of the Integrated Approach – but at the same time to address conflicts between the two objectives of “safety and soundness” v “consumer protection and transparency”. In jurisdictions that have adopted a twin peaks approach, investor protection is linked with market fairness and transparency mandates, and a single regulator is typically in charge of all three. The conduct-of-business focus tends to be delegated to securities regulators – who are generally the most experienced in this regard.

Advantages of this model include its ability to help insulate the prudential supervisor(s) from consumer-orientated concerns, meaning that they are able to give preference to safety and soundness in instances when the two may conflict, in favour of financial stability. It is also arguably the best of the models to ensure that transparency, market integrity and consumer protection receive sufficient priority. Further, it allows each regulator to hire employees with specific expertise matching their specific function. Although this is also possible in the first two models, they are generally recognised as being outdated.

There are disadvantages to the model, however: even if divided between regulators the tension between “safety and soundness” and “consumer protection and transparency” will still exist. A lack of oversight of these tensions and the market as a whole by one single regulator remains a risk, as discussed in the models above.



### **Jurisdictions (other than the UK) using the twin-peaks supervisory model**

In 1997 **Australia** reorganised its financial services regulation to a “twin peak” approach – separating prudential regulation from conduct-of-business regulation. The Australian Prudential Regulatory Authority (APRA) has a statutory duty to “promote financial system stability” in Australia. It regulates deposit-takers (banks, building societies, etc.), and is independent from the central bank. It is a prudential regulator that focuses on “safety and soundness” of the firms it supervises. Together with the Reserve Bank of Australia (RBA), it deals with firms that cannot meet obligations, with the RBA’s involvement being to provide liquidity support where necessary. The Australian Securities and Investments Commission (ASIC) regulates the business conduct of the market, and ensures consumer protection across the Australian market. It is not a prudential supervisor and issues guidelines and codes of conduct, and also has enforcement powers. The RBA is responsible for financial stability, interest rates and payment systems – and ensures clearing and settlement for securities and derivatives is done in a way promoting financial stability.

In 2008 the US Treasury identified it as the optimal long-term structure for the US, although this has not yet translated into a reality: there are still about 70 agencies involved in financial regulation and supervision. Ferran attributes this to bureaucratic self-interest among existing agencies in preserving the status quo and the inhibiting effect of the daunting scale of any exercise to effect deep restructuring of such a large and complex scale.

### **Excuse: The Central Bank as Supervisor**

While some jurisdictions have central banks exercising a prudential supervisory function (e.g. Brazil, France, Italy, Singapore, Spain and the Netherlands), others do not (Australia, Canada, China, Japan, Mexico, Qatar and Switzerland). In the UK, the PRA is part of the Bank of England but conducts its business independently from the latter.

It is important to have sound coordination and communication, facilitated by information sharing where possible, between supervisory agencies, central banks and finance ministries, whatever the model of regulation and supervision. Many jurisdictions have a special coordinating body to assist this, typically composed of the heads of agencies, senior officials from the central bank and finance ministry. The central bank in any jurisdiction emphasises the crucial importance of having a relationship with large financial institutions – and communication with them (and ideally involvement) in managing crises that may occur. This is so that in the event of crises, regardless of the regulatory structure in place, information-sharing and decision-making links between the central bank and other agencies take place.

There is no decisive literature or study on the relationship between the central bank and financial supervisory outcomes, and there is mixed evidence on whether keeping supervision within the bank is better than separating it. Dincer and Eichengreen have recently demonstrated that where supervision is within a central bank, countries tend to have more conservatively regulated financial systems – with higher capital ratios needed, though lower levels of bank credit according to some measures. They suggest that this translates into less investment for financially constrained firms, and lower economic growth.



A typical argument against this model is that this may give rise to conflicts of interest between monetary policy and supervisory functions. Ferran gives the example of a central bank not wanting to adjust interest rates if doing so might trigger a number of bank failures for which it could be blamed. Such contamination, which could increase the moral hazard in supervised banks, must be avoided. Also, accountability is seen as problematic in this context as supervisory functions within a central bank may conflict with the high level of independence that is afforded to it in its monetary policy role. In addition, the central bank may not be well positioned to regulate economies with sophisticated capital markets whose supervision requires specialist skills that are not usually associated with central bankers.

On the other side, central banks can be more efficient and effective because of their informational advantages. In particular, the central bank being the lender of last resort means that, if it is not the supervisor, the process of providing emergency liquidity could be hindered because the central bank did not have immediately to hand all the information it needed about the condition of the struggling bank. Lastly, having supervision located within the central bank may protect it from political interference.

Against the background of this mixed evidence, for instance, in Australia, conflict of interest concerns were relevant to the decision to allocate regulatory supervision outside the bank. However, France and the UK, for instance, have demonstrated that conflict of interest can be addressed by having a distinct entity within with central bank conduct micro-prudential supervision.

## **UK: 'TWIN PEAKS PLUS'**

The UK model could be more precisely described as "Twin Peaks Plus." It exposes the separation of conduct-of-business and safety-and-soundness or prudential supervision which is characteristic for the Twin Peaks set up. However, important further roles are allocated to other bodies so that there are a total of four major supervisors (BoE, PRA, FPC and FCA).

### **Bank of England (BoE)**

The Bank of England is the central bank for the UK and has a wide range of responsibilities to achieve monetary and financial stability. In addition to the regulatory remit of the FPC, MPC and PRA, it offers liquidity support to struggling financial institutions or manages failed institutions through its resolution process. It also facilitates payments and settlements across the system through its infrastructure, and provides bank services to the UK government and over 100 overseas central banks. FPC, MPC and PRA sit under BoE.

### **Financial Policy Committee (FPC)**

The Bank of England's Financial Policy Committee (FPC) is the UK's macro-prudential regulator<sup>5</sup>, and is responsible for the financial stability strategy. It identifies, monitors and takes action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. Its secondary objective is to support the economic policy of the Government, and receives an annual remit letter from the Treasury.

The FPC meets typically four times a year, and twice a year it publishes a Financial Stability Report. The Report sets out the committee's view on the main risks to financial stability and assesses how prepared the financial system is to withstand these risks. The Report also summarises the FPC's recent activities and assesses the impact of any actions it has taken.

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<sup>5</sup> "Breaking up is hard to do: the future of UK financial regulation", Black and Hopper, 2010.

Alongside the Prudential Regulation Committee and the PRA, the FPC contributes to the design and calibration of the BoE's stress testing framework.

It has two sets of powers – of direction and of recommendation. It can direct regulators to take action on a number of specific policy tools, as well as make recommendations to reduce risks to financial stability.

### Monetary Policy Committee (MPC)

The Bank of England's Monetary Policy Committee (MPC) meets eight times a year and is responsible for setting interest rates to meet the inflation target. Like the FPC, it receives an annual remit letter from the Chancellor.

The MPC is comprised of nine members in total – the Governor, three Deputy Governors for Monetary Policy, Financial Stability, and Markets and Banking, the Bank of England's Chief Economist and four external members appointed by the Treasury, to ensure the MPC benefits from external input and expertise. In early 2007 after a Treasury Committee hearing, the appointment process, which had been previously criticised for being opaque, was made more transparent with public procedures for appointments (in response to advertised procedures) being introduced.<sup>6</sup>

Interest rates are set following the majority vote in the Committee and minority views are published. The interest-rate decision is published alongside the minutes of the MPC's meetings. The Bank of England Inflation Report, which is published once a quarter, is published at the same time as the MPC meeting minutes and the interest rate decision. The Inflation Report provides an analysis of the UK economy and the factors influencing our policy decisions. It also includes the MPC's latest forecasts for inflation and output growth.

Transparency of the MPC is increased by the requirement that the Governor write to the Treasury if the target is not met, to explain why the target has not been hit, the action proposed to rectify this, how long it is expected to take before inflation will return

to the target and how the approach taken meets "the Government's objectives for growth and employment."<sup>7</sup> Letters were written in 2007 and 2008, demonstrating the enhanced accountability and transparency this process can have.<sup>8</sup>

### Prudential Regulation Authority (PRA)

The PRA was established under the Financial Services Act 2012, and officially launched operationally alongside the FCA on 1 April 2013. The Prudential Regulation Authority (PRA) at the Bank of England is responsible for this prudential regulation and supervision of 1,500 banks, building societies, credit unions, insurers and major investment firms.

The PRA has two primary objectives under the Financial Services and Markets Act 2000 (FSMA): 1) a general objective to promote the safety and soundness of the firms it regulates, focusing on the adverse effects that they can have on the stability of the UK financial system; and 2) an objective specific to insurance firms, to contribute to ensuring that policyholders are appropriately protected. Since 2014, the PRA has also had a secondary objective; to promote effective competition in the markets for services provided by PRA-authorised firms. It can be described as the UK's micro-prudential supervisor, whereas the FPC covers the macro-prudential side (see below).

The PRA was originally established as a subsidiary of the Bank of England, but the *Bank of England and Financial Services Act 2016* ended its status as a subsidiary, bringing the PRA within the BoE. Today, the *Prudential Regulation Committee (PRC)* has replaced the PRA's governance board. The creation of the PRC is a purely structural change – there are no changes to the PRA's objectives or functions. The change is intended to "deliver a simpler and more coherent governance structure within the Bank, while ensuring that the Prudential Regulation Authority remains strongly focused on its statutory objectives".<sup>9</sup>

<sup>7</sup> Philip Arestis, [https://www.boeckler.de/pdf/v\\_2008\\_07\\_27\\_arestis\\_academic.pdf](https://www.boeckler.de/pdf/v_2008_07_27_arestis_academic.pdf).

<sup>8</sup> Ibid.

<sup>9</sup> <https://www.bankofengland.co.uk/news/2017/february/prudential-regulation-committee-replaces-pra-board>

<sup>6</sup> Ibid.



The PRC has twelve members, including the Governor of the Bank of England and four Deputy Governors and the Chief Executive of the PRA. The remaining six members come from outside the bank.

Since the PRA is, together with the MPC and the FPC,<sup>10</sup> within the Bank of England, monetary policy, macro-prudential policy and (part of) micro-prudential policy are all under one institution.

### **Financial Conduct Authority (FCA)**

Like the PRA, the FCA was also established under the Financial Services Act 2012, and launched on 1 April 2013. It regulates the conduct of more than 56,000 businesses and is the prudential regulator for more than 18,000 businesses (excluding the ones that are regulated by the PRA for prudential matters). The FCA took over responsibility for conduct and relevant prudential regulation from the FSA. Its strategic objective is to ensure that the relevant markets function well and its operational objectives are to protect consumers, protect the integrity financial markets, and to promote effective competition.<sup>11</sup>

The FCA has significant powers, including the power to regulate conduct related to the sales and marketing of financial products, to specify minimum standards and to place requirements on products, to investigate organisations and individuals, and to ban financial products for up to a year while considering an indefinite ban.

To finance FCA's work, FCA charges fees to the firms they authorise and some other bodies such as recognised investment exchanges or registered firms. According to the most recent annual report 2017, the total income is 574.9 million pounds, and among them. Of that, 554.1 million is fee income and 20.8 million

is other income, which mainly comes from the extra services that FCA provided, like Skilled Person reports.

### **Regulatory perimeter of the FCA**

The FCA is responsible for regulating broad sectors of financial services. Its perimeter comprises general insurance and protection (5800 firms), investment management (3000 firms with nearly £7tn assets, pensions and retirement income (230 firms), retail banking (1300 firms with over 72 million active personal current accounts in the UK and retail deposits of over £1.55tn), retail investments (5850 firms), retail lending (30,000 firms), and wholesale financial markets (1650 firms). The foregoing includes internet-based retail portals with roughly £600bn in assets under administration. Further, the FCA created in 2015 a separate body, the Payment System Regulators, to regulate and supervise payment systems.

The FCA mainly enforces the rules on approved persons, the senior managers and certification regime, the rules on change in control, the regime on appointed representatives and principals, the EU passporting regime, any variation of permission, cancellation of authorisations, waivers and modifications, capital requirements permissions, fees and levies, regulatory reporting and administers any change of legal status.

The FCA also regulates financial markets, including exchanges and issuers of securities in respect of market integrity, ensuring stability and resilience; access, effectiveness and predictability; fairness and cleanliness; and the prevention of financial crime. At the same time, it is charged with the protection of market users, ie securing appropriate degrees of protection for those who use or participate in markets. It further promotes effective competition between providers for goods and services in the interests of market users. A primary objective of the FCA is consumer protection. These are also done through institutions independent from FCA, such as the Money Advice Service, the Financial Ombudsman Service and the Financial Services Compensation Scheme (FSCS).

<sup>10</sup> <https://www.bankofengland.co.uk/news/2017/february/prudential-regulation-committee-replaces-pra-board>

<sup>11</sup> The FCA's objective to get financial markets to work well is extremely important for how it operates. Obviously, financial markets that work well will obviously promote growth. However, getting financial markets to work well can also improve corporate governance (see Schmidt and Fahlenbrach (2017)) and good corporate governance can potentially improve financial stability. Financial market development also reduces extreme poverty (see Ross Levine's presentation <http://www.systemicrisk.ac.uk/sites/default/files/images/7.%20Ross%20Levine%20%20Regulating%20for%20prosperity.pdf>).



## Regulatory framework

FCA tries to approach conduct regulation in a uniform framework. As for regulating different firms, the FCA is undertaking a two-dimension framework: sector-based (fixed-portfolio firms) and activity-based. There are some key issues of each sector, originating from the intrinsic differences of different businesses. Compared to a purely sector-based regulation in the US, the advantage of the UK approach is that all regulation is done by one entity, hence the responsibility is clearly defined.

Roughly speaking, these are main parts in FCA: Authorisation, Supervision, Enforcement, and Policy. Cross-sector priorities of conduct regulation exist in respect of firms' culture and governance, financial crime; and anti-money laundering; promoting competition and innovation; technological change and resilience; treatment of existing customers; consumer vulnerability and access to financial services.

## FCA's role in financial innovation

In October 2014, the FCA launched Project Innovate, which entails three schemes: the Innovation Hub, to help small businesses grow; the Regulatory Sandbox, that allows innovative firms to test their new business ideas; and RegTech, to adopt new technologies to achieve better regulation.

The Innovation Hub consists of a dedicated team and acts as a contact for innovator businesses. They provide help for these businesses to understand the regulatory framework and how it applies to them and assist in preparing and making an application for authorisation, to ensure the business understands the regulatory regime and what it means for them. Further, they are supposed to facilitate the entry of innovative overseas firms to the UK, thereby increasing innovation and competition in UK financial services markets, and, likewise, facilitating the expansion of UK-based innovative firms into overseas markets, making them potentially more sustainable challengers in the UK.

The Regulatory Sandbox is the 'first of its kind in the world.' It allows businesses to test innovative products, services, business models and delivery mechanisms in

the real market, with real consumers. A clear objective (e.g., reducing costs to consumers) is expected from these tests, and firms will test their innovation for a limited duration on a limited consumer group for a relatively small scale. The Sandbox is open to both authorised firms and unauthorised firms that require authorisation, and technology businesses. The Sandbox seeks to provide an ability to test products and services in a controlled environment with a reduced time-to-market at potentially lower cost. At the same time, appropriate consumer protection safeguards are identified, with the ultimate goal to provide easier access to finance. To this end, the Sandbox offers restricted authorisation. Although some regulations may be waived, the FCA oversees the tests and has a safeguard system for consumers.

The 'RegTech' strand of the FCA was built on the success of Project Innovate. Since the first half of 2015, the FCA started to explore how regulatory requirements and technology could come together through regulatory technology. It applies to new technologies developed to help overcome regulatory challenges in financial services, relating to efficiency and collaboration (alternative reporting methods, shared utilities, cloud computing, online platforms); integration and standards (semantic tech and data point models, shared data ontology, application programme interface); predictions (big data analytics, risk and compliance monitoring, modelling/visualisation technology, machine learning and cognitive technology); and new technologies (blockchain/distributed ledger, biometrics).

## Treasury

Her Majesty's Treasury (HMT) is the UK Government's economic and finance ministry. It controls public spending, sets the direction of UK economic policy and aims to support sustainable economic growth. The mandate of the Treasury covers a number of priorities which are directly related to the supervision and regulation of the financial sector: creating stronger and safer banks, making it easier for people to access and use financial services; improving the protection of customers and the economy; to ensure the stability of the macro-economic environment and financial system; enabling strong, sustainable and balanced growth.

The Treasury has strategic oversight of the macro-prudential framework, including the Financial Policy Committee's remit. It also provides the framework for the Monetary Policy Committee, ensuring it can "play its role in an accountable and credible manner."<sup>12</sup>

### Co-ordination of policies

#### Fiscal and monetary policy (Treasury-Bank of England)

In 1992 the UK was forced to suspend Britain's membership of the European Exchange Rate Mechanism (ERM) – after measures taken (including raising interest rates from 10%, to 12%, and then to 15%) did not stop the pound from falling lower than its minimum level in the ERM.<sup>13</sup> From 1992 to 1997 inflation targeting was introduced, which required an inflation target of between 1 and 4%, regular meetings between the Chancellor and the Governor of the Bank of England to decide the interest rate level, and preparation of an inflation report.<sup>14</sup>

The Bank of England was granted independence to determine its monetary policy in 1997 and was given more clearly defined objectives<sup>15</sup> via the operational Monetary Policy Committee (MPC). As outlined above, the MPC meets regularly to set the interest rate to achieve the inflation target set by the Treasury. It has a "constrained discretion"<sup>16</sup> – being subject to scrutiny by the Treasury Committee and the Lords Select Committee.<sup>17</sup>

A representative from the Treasury also sits in all MPC meetings – they can discuss policy issues but cannot vote. Their presence is designed to ensure the MPC is "fully briefed on fiscal policy developments, and other aspects of the Government's economic policies, and that the Chancellor is kept fully informed about

monetary policy".<sup>18</sup> While the presence of the Treasury representative does not guarantee coordination of monetary and fiscal policies, it has been argued that coordination is improved by their presence, at any rate.<sup>19</sup>

In March 2013, the Treasury published a report detailing its review of Monetary Policy. The report recognised that review was needed in light of the significant challenges to inflation targeting after the financial crisis, with recovery taking longer than expected.<sup>20</sup> As a result of the review the Government decided to update the remit of the MPC which increased coordination in a number of respects: the remit now requires that, alongside the requirement for the exchange of open letters between the Governor of the Bank of England and the Treasury if inflation moves away from the target by more than 1% in either direction, the "open letter from the Governor should be sent alongside the minutes of the MPC meeting that followed the publication of the CPI data and referring as necessary to the Bank's latest Inflation Report and forecasts, covering the MPC's judgements on the trade-offs inherent in setting monetary policy." This measure aims to "allow the MPC time to form and communicate its strategy towards returning inflation to the target after consideration of the trade-offs" while allowing for "more meaningful exchange about MPC's strategy" than has been previously possible.<sup>21</sup>

The remit was also updated after this review to ensure the coordination of the "frameworks for monetary policy and macro-prudential policy, operated by the MPC and the FPC of the Bank of England, respectively."<sup>22</sup>

The independence of the Bank of England as the UK's central bank plays a role in achieving effective monetary policy.<sup>23</sup> Its independence in 1997 and its withdrawal from the Exchange Rate Mechanism increased its ability to "coordinate and restore financial stability".<sup>24</sup>

<sup>12</sup> HM Treasury single departmental plan: <https://www.gov.uk/government/publications/hm-treasury-single-departmental-plan-2015-to-2020/hm-treasury-single-departmental-plan-2015-to-2020>.

<sup>13</sup> [http://news.bbc.co.uk/onthisday/hi/dates/stories/september/16/newsid\\_2519000/2519013.stm](http://news.bbc.co.uk/onthisday/hi/dates/stories/september/16/newsid_2519000/2519013.stm)

<sup>14</sup> Philip Arestis, [https://www.boeckler.de/pdf/v\\_2008\\_07\\_27\\_arestis\\_academic.pdf](https://www.boeckler.de/pdf/v_2008_07_27_arestis_academic.pdf).

<sup>15</sup> Treasury report, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/221567/ukecon\\_mon\\_policy\\_framework.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221567/ukecon_mon_policy_framework.pdf)

<sup>16</sup> Philip Arestis, [https://www.boeckler.de/pdf/v\\_2008\\_07\\_27\\_arestis\\_academic.pdf](https://www.boeckler.de/pdf/v_2008_07_27_arestis_academic.pdf).

<sup>17</sup> Ibid.

<sup>18</sup> <https://www.bankofengland.co.uk/about/people/monetary-policy-committee>

<sup>19</sup> Philip Arestis, [https://www.boeckler.de/pdf/v\\_2008\\_07\\_27\\_arestis\\_academic.pdf](https://www.boeckler.de/pdf/v_2008_07_27_arestis_academic.pdf).

<sup>20</sup> Treasury report, p 3.

<sup>21</sup> Treasury report, p 4.

<sup>22</sup> Treasury report, p 4.

<sup>23</sup> <http://onlinelibrary.wiley.com/doi/10.1111/j.1475-5890.2002.tb00057.x/abstract>

<sup>24</sup> Bhundia and O'Donnell, "UK policy coordination: the importance of institutional design" <https://www.degruyter.com/downloadpdf/j/jcbtp.2017.6.issue-3/jcbtp-2017-0022/jcbtp-2017-0022.pdf>

Central bank independence is currently being challenged, and many think it may decline in the UK and the Eurozone in the next 48 months.<sup>25</sup> While in part due to pure populism, others argue that a “changing landscape in terms of the overall economy and central banks’ responsibilities relative to the times when their independence took off” – especially because the “original rise in central bank independence was motivated by successful taming of inflation in the 1980s” (Martin Ellison, Oxford). Also, some see the credibility of central banks undermined, as a result of recent policies that central banks have pursued since the financial crisis (see, eg, Fabrizio Coricelli, Paris). Still, “conventional theory” still argues for the importance of central bank independence in achieving low and stable inflation – though there is evidence of views differing on this.<sup>26</sup>

There remains a general consensus still, however, that central bank independence is desirable given that it provides a “credible commitment”<sup>27</sup> not to increase inflation – if there was political influence “politicians would be tempted to set looser policy and unexpectedly increase inflation in order to lower unemployment” and “fiscal authorities would be tempted to inflate away the debt, leading to a large inflation premium paid on the borrowing costs of the government”.<sup>28</sup>

While central bank independence has been widely acknowledged as important in setting monetary policy for price stability, it is also acknowledged that some level of coordination between monetary and fiscal policy can enhance the effectiveness of monetary policy. If fiscal and monetary policy have a “common objective – for example maximisation of social welfare, this need not imply that the two authorities should lose their independence”.<sup>29</sup> While coordination is important, so too is “a clear division of responsibilities between” monetary and fiscal policy actors. Coordination works best “if it manages to improve the understanding of the objectives and responsibilities of the respective policy areas and

does not dilute accountability”.<sup>30</sup> It has been suggested that this could be effectively achieved by delegating fiscal policy “outside the government”, which “could take the form of a fiscal regulator.”<sup>31</sup> Arestis has argued for the benefits of such coordination – in particular noting that it could contribute to reducing unemployment and income equality.<sup>32</sup> He suggests that, in terms of fiscal policy as an instrument of stabilisation, “proper coordination might be the way forward.”<sup>33</sup>

### Monetary policy and financial stability (MPC-FPC)

There is significant support<sup>34</sup> for the need for coordination of fiscal and monetary policy, which is generally acknowledged to have a stabilising effect. Fiscal policies naturally have monetary policy implications if they affect price development, where monetary policy is focused on price stability. Therefore “a stability oriented monetary policy will take fiscal policy measures into account in its analysis.”<sup>35</sup>

After the recent financial crisis, it became particularly apparent that the price stability that monetary policy sought to achieve could not guarantee financial stability. To increase the financial resilience and stability of institutions, the emerging model of financial regulation sees monetary and macro-prudential policy coordinated. It is suggested that where “both monetary and macro-prudential functions are housed within a central bank, coordination is improved” – however “safeguards are needed to counter the risks from dual objectives”.<sup>36</sup>

The MPC is required to have regard to the policy actions of the FPC in certain circumstances,<sup>37</sup> and, in the same way, “the Government will also ask the Financial Policy Committee to note in the records of its meetings, its policy

<sup>25</sup> <http://blogs.lse.ac.uk/businessreview/2017/01/10/is-the-era-of-central-bank-independence-drawing-to-a-close/>

<sup>26</sup> Ibid

<sup>27</sup> Ibid

<sup>28</sup> Ibid

<sup>29</sup> Arestis, [https://www.landecon.cam.ac.uk/research/real-estate-and-urban-analysis/centres/ccepp/copy\\_of\\_ccepp-publications/wp06-09.pdf](https://www.landecon.cam.ac.uk/research/real-estate-and-urban-analysis/centres/ccepp/copy_of_ccepp-publications/wp06-09.pdf), p 16.

<sup>30</sup> “The role of fiscal and monetary policies in the stabilisation of the economic cycle” – <https://www.ecb.europa.eu/press/key/date/2005/html/sp051114.en.html>, section 6.

<sup>31</sup> Ibid.

<sup>32</sup> <https://www.repository.cam.ac.uk/bitstream/handle/1810/246317/ARESTIS-PAPER-FNL.pdf?sequence=1>

<sup>33</sup> Ibid, 18.

<sup>34</sup> Arestis, [https://www.landecon.cam.ac.uk/research/real-estate-and-urban-analysis/centres/ccepp/copy\\_of\\_ccepp-publications/wp06-09.pdf](https://www.landecon.cam.ac.uk/research/real-estate-and-urban-analysis/centres/ccepp/copy_of_ccepp-publications/wp06-09.pdf), p 17.

<sup>35</sup> “The role of fiscal and monetary policies in the stabilisation of the economic cycle” – <https://www.ecb.europa.eu/press/key/date/2005/html/sp051114.en.html>, section 6

<sup>36</sup> ECON Committee Report p 4.

<sup>37</sup> Treasury report, pg 10, extract from Governor’s letter.

statements and its Financial Stability Reports how it has had regard to the policy settings and forecasts of the MPC.<sup>38</sup> This coordination is also assisted in practice by the membership cross-over between the FPC and the MPC.

In the 22 November 2017 letter from the Treasury to the Governor of the Bank of England, the former confirmed to the continued coordination between the Monetary Policy Committee and the FPC:

*“The MPC and the Financial Policy Committee should continue to have regard to each other’s actions, to enhance coordination between monetary and macroprudential policy. This coordination has enhanced the strength and resilience of the UK’s macroeconomic framework. It has performed well through testing times, and is well equipped to address future challenges.”<sup>39</sup>*

Ultimately, the “impact of monetary policy is contingent on institutional design” which “implies that there is a prospect that the aspect of policy coordination and combination of macroeconomic policies may also be influenced by changes in the institutional design and hence their implications for the financial sector”.

On the other side of the Atlantic, the US Financial Stability Oversight Council has a clear statutory mandate that creates for the first time collective accountability for identifying risks and responding to emerging threats to financial stability. It is a collaborative body chaired by the Secretary of the Treasury that brings together the expertise of the federal financial regulators, an independent insurance expert appointed by the President, and state regulators. The Council has important new authorities to constrain excessive risk in the financial system. For instance, the Council has the authority to designate a nonbank financial firm for tough new supervision to help minimise the risk of such a firm from threatening the stability of the financial system. Additionally, to help with the identification of emerging risks to financial stability, the FSOC can provide direction to, and request data and analyses from, the newly created Office of Financial Research (OFR) housed within Treasury.

<sup>38</sup> Ibid.

<sup>39</sup> “Remit for the Monetary Policy Committee”, letter to the Governor of the Bank of England, 22 November 2017. [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/661066/PU2118\\_MPC\\_Remit\\_Autumn\\_Budget\\_2017\\_WEB.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/661066/PU2118_MPC_Remit_Autumn_Budget_2017_WEB.pdf)

The European Central Bank has highlighted the need for separate monetary and fiscal policy – and clear accountability – but has noted that exchange of information between the two authorities can assist the outcome as long as neither policy is reliant on the other.<sup>40</sup>

*“A single monetary policy that is committed to maintaining price stability in the Euro area will by itself facilitate “appropriate” economic outcomes in the Member States. If national fiscal authorities correctly perceive the behaviour of the single monetary policy they will take actions that would likely lead to implicitly “co-ordinated” policy outcomes ex post. Of course, an open exchange of views and information between individual policy actors – without any commitment or mandate to take and implement joint decisions – will assist the overall outcome, if it manages to improve the understanding of the objectives and responsibilities of the respective policy areas and does not dilute accountability.”*

In the UK, the ideal level of coordination described in this paragraph is arguably achieved – with Treasury directing the Governor of the Bank of England that the FPC and the MPC must “have regard to each others actions – to enhance coordination between monetary and macroprudential policy.”<sup>41</sup> This is ensured by the cross-membership of these committees. They are, under this approach, aware of each other’s actions without being encouraged to be reactive to the other. Such coordination has to date “enhanced the strength and resilience of the UK’s macroeconomic framework”<sup>42</sup>. In putting this level of coordination in place the Government was careful to “prevent the dilution of the MPC’s inflation remit” – and was aware that “the objectives of price stability and macro-prudential are sufficiently distinct that they should be kept separate”.<sup>43</sup>

<sup>40</sup> <https://www.ecb.europa.eu/press/key/date/2005/html/sp051114.en.html>

<sup>41</sup> Remit letter – 8 March 2017: <https://www.bankofengland.co.uk/-/media/boe/files/letter/2017/chancellor-letter-080317-fpc.pdf?la=en&hash=7B99B9B412E160F79FB2411F26A10F282FDC7BB6>

<sup>42</sup> Ibid.

<sup>43</sup> “A new approach to financial regulation – building a stronger system” 2.103 – 2.105: [https://books.google.co.uk/books?id=1kqgsGNvjIEC&pg=PA35&lpg=PA35&dq=mpc+meetings+fpc+rep&source=bl&ots=PW9LE\\_d0kA&sig=zOXvN\\_yIKrF112bqe\\_LvlsM03xA&hl=en&sa=X&ved=0ahUKewjn0rkV04fZAhVEasAKHdCeBJUQ6AEINDAD#v=onepage&q&f=false](https://books.google.co.uk/books?id=1kqgsGNvjIEC&pg=PA35&lpg=PA35&dq=mpc+meetings+fpc+rep&source=bl&ots=PW9LE_d0kA&sig=zOXvN_yIKrF112bqe_LvlsM03xA&hl=en&sa=X&ved=0ahUKewjn0rkV04fZAhVEasAKHdCeBJUQ6AEINDAD#v=onepage&q&f=false)



### **Conduct and prudential supervision (FCA–PRA)**

The breaking up of the Financial Services Authority (FSA) and its replacement with two separate regulatory authorities—the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA)—has been a controversial aspect of the reform. On the one hand, no one would dispute the advantages of specialised regulatory agencies; on the other hand, extra care is needed to ensure that the erection of institutional boundaries does not pose a threat to the coherent implementation of their distinctive agendas.

The issue of policy coherence is of imminent practical significance, given the industry's concerns that the cost of regulation will increase as a result of the difficulties that the FCA and the PRA will encounter in avoiding inconsistencies and unnecessary duplications. The cohesive implementation of the FCA and PRA programmes to a large extent depends on the ability of the new regulators to attend to matters of their expertise while at the same time being mindful of how the entire system of financial regulation fits and works together. Although one can hope that in due course the PRA and the FCA will be able to overcome points of disagreement, there are several other steps that may be taken in order to speed up this process and increase the chances that the new coordination scheme will be a success story.

The distinctiveness of the FCA and PRA is further highlighted by the fact that the new regulators produce their own separate rulebooks and are subject to separate mechanisms of accountability.

The MoU between the FCA and PRA aims to avoid any inconsistencies and duplications and to have regard to principles of good corporate governance.

The FPC's power to make recommendations and give directions constitutes further evidence of the interconnected nature of the FCA and the PRA (as part of the Bank of England Group) tasks. This was conceived as an appropriate mechanism to ensure that the PRA and FCA will not be deprived of the expertise of the FPC in the Bank of England with respect to matters of financial stability. Specifically, the FPC is a policy committee rather than a regulator, which means that it will not be supervising financial firms and markets directly.

However, tensions may remain, especially when prudential and systemic stability concerns are seen to override consumer protection issues in the case of institutional failures. The threshold of coordination is not entirely clear and the PRA's power to veto an FCA decision may be problematic as it injects an aspect of hierarchy between them (the MoU states that the FCA is under no obligation to comply with a PRA direction if, in its opinion, this would be incompatible with any EU or international law obligation). The PRA veto hasn't been used in practice which means that both have worked together to ensure issues are resolved early on. This is one illustration of the importance of practical day-to-day working together between the PRA and the FCA.

The inclusion of an umbrella FCA–PRA policy objective would be helpful to furnish the new regulators with an integrative point of reference and a common narrative for policy coherence.

### **Supervisory Strategy: Risk and Principles-based**

The term 'supervisory strategy' describes how regulatory rules of prudential regulation are in practice imposed, or enforced, on financial institutions. More precisely, the supervisory strategy consists of three different aspects, notably (a) what criteria supervisors use to allocate supervisory attention and resources to a specific financial institution; (b) what mechanism of entry of the relevant rule into the financial institution is used; and, (c) how behavioural obligations are set. In the UK, these crucial questions are decided on the basis of three interlinked concepts, named 'risk-based', 'management-based' and 'outcome based' regulation.

Under the risk-based view, resources are allocated in view of the potential risk entailed by the failure of a specific institutions, taking into account also the likelihood of that risk materialising. Obviously, the consequence of this approach is that more resources and attention are allocated to bigger, interconnected or critical firms, whereas smaller firms might to some extent go under the radar.

In the UK, there is generally no prescription in precise terms on how to comply with the relevant rules: i.e.,



no concrete behaviour is prescribed for every person transacting. Rather, management is used as a suitable point of entry to make a firm's staff comply with the rules. This presupposes that regulators have trust in senior management (an expectation that was deceived in the past). Still, effective regulation of an innovative market cannot work without that trust. The question is therefore rather one of striking the right balance. Hence, since the financial crisis, the pendulum has swung towards requiring an upgrade of internal compliance procedures, requesting changes to the internal culture of firms, and, first and foremost, changing the incentive system.

Lastly, the idea of 'principles-based' regulation refers to the advantages and disadvantages, respectively, of very detailed behavioural rules imposed on firms, as compared to outcomes that their behaviour should produce, or broader principles that must underlie their behaviour. This aspect has been the hallmark of UK regulation for quite some time, albeit it was heavily criticised during and after the financial crisis. Still, very detailed rules can lead to the phenomenon of senseless ticking of boxes while losing sight of the underlying reasoning. However, the critique that principles-based regulation might equal 'loose' regulation lets the UK switch to a slightly adapted regulatory strategy. It concentrates on the outcome by prescribing what must be achieved (or must not happen) – which still leaves room for managerial freedom on how the outcome is achieved, and which still combats the dangers of regulation overburdened with detail – potentially inducing an unhealthy concentration on the words of the law.

To give a concrete example, one of the unique features of the FCA is its mandate to promote competition. The competition tool plays a key role in the principles-based regulation. If the FCA detects a market failure, it could write rules to try to correct it directly. However, the rules will probably not capture exactly how the market works (or will not keep pace with how the market evolves), so this approach will often produce a big gap between what the regulators want the rules to do and what they actually do. In practice, the FCA tries to accomplish its objectives indirectly where possible, by getting the markets to work well by promoting competition. Competitive markets are also fairer markets. An increase in banking competition promotes an increase in new firms, leads to old firms exiting, reduces local inequality, and potentially improves financial stability.

### 3.

## China's system of financial regulations: challenges

Dominated by a large banking sector, and with rapidly growing securities' markets and non-bank financial intermediaries (NBFIs), the Chinese financial system has grown significantly in size and complexity, and continues to do so. Financial assets grew from 263 percent of GDP to more than 467 percent in 2016. Within the banking sector, the government remains the majority shareholder of banks whose primary function is the funding state-owned enterprises (SOEs) and large government projects, although recently these banks diversified towards households. Unsurprisingly, a large portion of nonperforming loans (NPLs) resulted from poor decisions made by state-owned banks to lend to state sectors, especially after the 4 trillion stimuli package since 2018 global crisis. The domestic Chinese stock market is very large: its A-share market is the second largest in the world in terms of market capitalisation after the United States. However, it is marked by inefficiency and volatilities<sup>44</sup> and serves mostly large and/or state-owned firms. The bond market is the world's third largest. However, it is dwarfed by the banking sector as a source of funding for private corporations.<sup>45</sup> The alternative financing channels, such as NBFIs which includes insurance to trust companies, often categorised as falling within the shadow-banking sector, have played a critical role in supporting the growth of SME and consumer sectors, which are not well served by the banks and markets.

Going forward, as the Chinese economy is transitioning from an export-oriented to an innovation or consumption-driven economy, there are two types of major issues facing the financial system: 1) the need to improve the efficiencies of banks and financial markets and expand their services to dynamic sectors of the economy and beyond the state sector; and 2) the need to avoid instability in the increasingly complex financial sector stemming from either the NPL/credit overhang problem in the banking sector, and/or a crash in the asset market, and a negative spill over from an over-expanding shadow-banking sector. In this environment, it becomes increasingly important to strengthen systemic risk oversight, further improve regulation and supervision.

The existing regulatory approach in China was established more than a decade ago and is close to the traditional approach seen in the United States - with regulatory authorities established along institutional or sector-based lines, i.e. separate authorities established to regulate the banking sector, the insurance sector and the securities sector: the China Banking Regulatory Commission (CBRC), the China Insurance Regulatory Commission (CIRC) and the China Securities Regulatory Commission (CSRC).<sup>46</sup> This regime is nicknamed "one bank (PBoC) and three committees (CBRC, CSRC, and CIRC)." Since the existing regulatory system has been in place, China has experienced dramatic growth in financial products and services and also increased complexities and interlinkages in the financial systems. Further, as the impact of financial innovation and financial conglomerates has increased, the weaknesses of the current regulatory structure have become evident, particularly in the area of regulatory overlap and regulatory coordination. The reform is urgently needed. In July 2017, a Financial Stability and Development Committee (FSDC) was created under the State Council. On 13 March 2018, it was announced during the National People's Congress that CBRC and CIRC will be merged and some of their functions including prudential oversights and rule-making power will be moved to the PBoC. The PBoC emerges as a pivot in the new regulatory structure. In the midst of these reform measures, we outline below four major challenges facing the regulatory systems in China.

<sup>44</sup> See Morck, Yeung & Yu (2000) for evidence.

<sup>45</sup> In 2016, private corporations issued less than RMB 200 billion of bonds while bank lend these firms RMB5 trillion.

<sup>46</sup> For a discussion about the historical development of banking regulation in China, see Guo Li, "The Collapse of the Glass-Steagall Wall and Its Impact on China's Banking Law" [2003] *Journal of International Banking Law and Regulation* 184.

## POTENTIAL CONFLICTS BETWEEN POLICIES THAT PROMOTE ECONOMIC GROWTH AND THAT ENFORCE FINANCIAL STABILITY

One challenge that has been identified by the International Monetary Fund (IMF) in its 2017 financial system stability assessment of China is the impact of national economic policies and the state-owned economy on the realisation of regulatory objectives. In respect of the monetary and fiscal policies, the IMF has noted that “[these policies] aimed at supporting employment and growth have, in recent years, been expansionary. Pressures to keep non-viable firms open—rather than allowing them to fail—are strong, particularly at the local government level, where these objectives, at times, conflict with financial stability.” Previous IMF and IOSCO reports have also noted that the potential conflict between Chinese supervisory objectives and its commercial and social objectives that relate to the development of financial service industry, which exists in many other (especially developing) countries – but can be more acute in China. The dual aim both of promoting soundness in the markets and promoting market development involves balance and compromises, especially with respect to financial innovation, which is the most dynamic sector of the financial industry currently.<sup>47</sup>

However, the concern about this potential conflict between regulatory and economic/social objectives is more theoretical than practical in nature. Allen, Qian, and Gu (2017) have pointed out that “the [state-]ownership structure [has] served [the banking system] well in terms of avoiding the crises encountered by major financial institutions in developed countries that were at the centre of the 2007–2009 global financial crisis.” They treat the existing NPL problem in the banking sector as the fiscal problem rather than relating to financial stability issues. It remains an issue that needs to be taken into account in terms of the regulatory design of China’s financial system, as discussed further in Chapter 4, taking lessons from the UK’s experience in balancing economic growth and financial stability objectives.

## COMPLEX AND INTER-CONNECTED FINANCIAL SYSTEMS AND SYSTEMIC RISK ASSESSMENT

Studies done by Tsinghua University National Institute of Financial Research (NIFR) have tracked systemic risk level and development. The most recent report has shown that in the past twelve years (June 2006 – December 2017), a measure of catastrophic risk in the financial system (CATFIN) has remained in a relatively stable and safe range (Figure 1 – see over).<sup>48</sup> Its volatility is comparable to the historical average. These indicate the predictability and stability of the systematic financial risks at the macro level, which diminishes the possibility of the occurrence of systemic events in the foreseeable future.

It has also highlighted that the banking sector contributes most to the systemic risk of the financial industry. Among all banks, joint-stock commercial banks deserve more attention since they have the lowest capital adequacy ratio in the banking sector. It is reported that this is due to both internal and external factors. Internally, the joint-stock commercial banks lacked sufficient governance and have seen rampant illicit transactions since the first quarter in 2017, including selling fictitious wealth management products, fabricating illegal official stamps, and providing illegal guarantees. Externally, the joint-stock banks have been more seriously impinged by newly established regulations, which have penetrated the whole banking sector and supervised the asset management products under unified rules. However, joint-stock banks face higher pressure to attain high performance as well as fiercer market competition than state-owned banks. Therefore, they tend to be more inclined to take risks and as a result are under greater scrutiny within the augmented regulation framework.

<sup>47</sup> People’s Republic of China: Detailed Assessment Report: Basel Core Principles for Effective Banking Supervision, April 5, 2012, 27. People’s Republic of China: Detailed Assessment Report: IAIS Insurance Core Principles, April 5, 2012, 8, 9. People’s Republic of China: Detailed Assessment Report: IOSCO Objectives and Principles of Securities Regulation, April 5, 2012, 3

<sup>48</sup> Tsinghua University National Institute of Financial Research (NIFR): Systemic Risk of China’s Financial System 2017 (No. 2017-11)

Figure 1

### Macro dimension: The time series of CATFIN (2006-2017)

Source: Tsinghua University NIFR

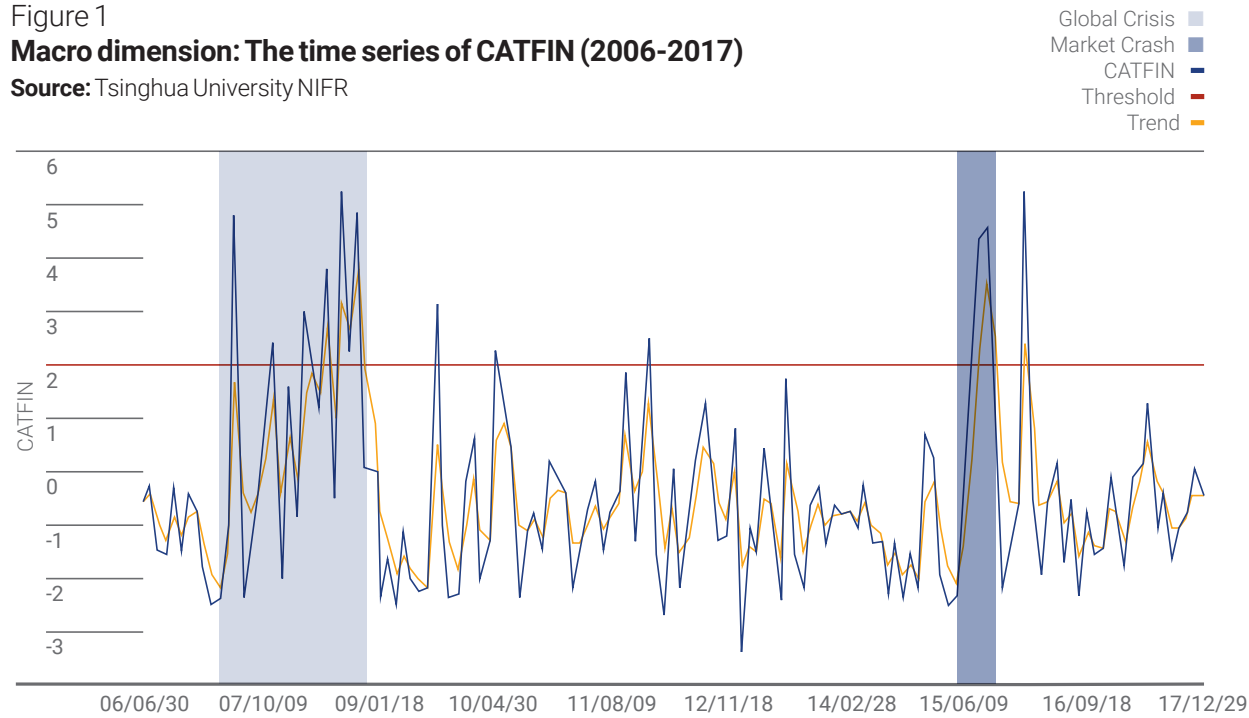
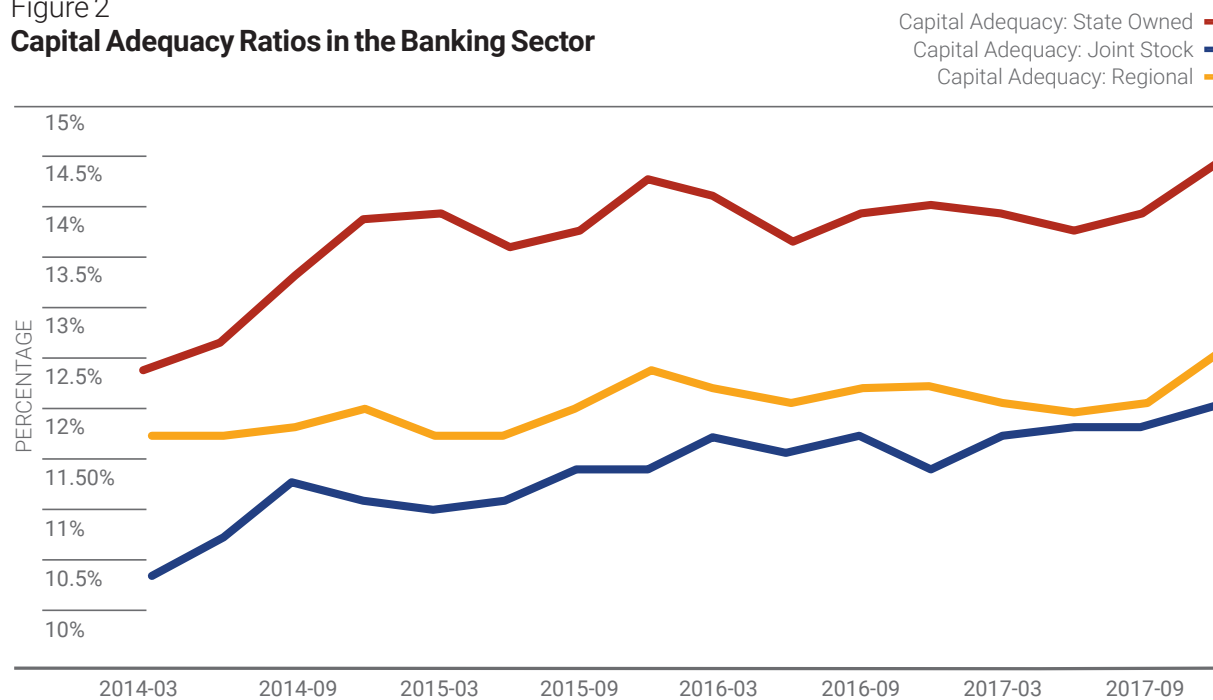


Figure 2

### Capital Adequacy Ratios in the Banking Sector





## REGULATORY VACUUM AND OVERLAP

With the rapid development of cross-sector, specifically cross-market financing activities since late 2000, the current regulatory regime has become increasingly problematic. On the one hand, regulatory inconsistency across sectors creates a supervision vacuum, as seen in areas such as P2P lending, trusted companies, entrusted loans, bankers' acceptance, and wealth management products. The lack of effective supervision in these markets poses great risk to the Chinese economy as a significant fraction of credit provision originates from these shadow banking channels. On the other hand, certain parts of the financial system are excessively regulated. There are situations where financial products, transactions and other activities are subject to the regulations of two or more regulators, giving rise to potential conflicts and difficulties in compliance. One prominent example is the bond market. Figure 3 shows the five issuance regulators for different types of borrowers. Conflicts among regulators are unavoidable and regulatory arbitrage is rampant – the segmented regulatory structure of the Chinese bond market has been associated with many abnormalities in that market. For example, AAA rated issues are more frequently observed than issues with other ratings (See Figure 4). Both regulatory gaps and overlap might lead to regulatory arbitrage activities and potential threatens financial stabilities.<sup>49</sup>

This is a challenge facing all Chinese regulators. A prime example is the regulatory overlap between CBRC and the CIRC, noted by IOSCO. It comments that '[w]here banking or insurance companies engage in securities type activities, such as establishing and distributing wealth management products, the CBRC and CIRC have corresponding regulatory authority.'<sup>50</sup> The recent overhaul in merging CBRC and CIRC proposed by the Chinese government is a direct response to this overlap and the resulting regulatory arbitrage in the insurance industry. It is a step towards modernising the Chinese regulatory system.

The regulatory overlap between CBRC and PBoC has also been observed. For example, Godwin, Li and Ramsay (2016) have noted that "the responsibilities of the PBOC include 'planning financial industry reform and development strategies', 'promoting the coordinated and healthy development of the financial industry', 'promoting the orderly opening up of the financial industry' and 'formulating rules on regulation of financial holding companies together with other financial regulatory authorities and monitoring financial holding companies and cross-sector financial products.' As a result, there is significant potential for overlap between the functions of the PBoC and those of the CBRC."<sup>51</sup> This issue remains a hot discussion topic especially regarding the extent of the PBoC and CBRC's responsibilities as macro and micro-prudential regulators. According to a proposal unveiled on 13 March 2018 during the National People's Congress, there will be a clear delineation of responsibilities between the PBoC and newly merged CBIRC. The former will take over prudential oversights and law-making functions while the later will be responsible for enforcement and supervision.<sup>52</sup>

<sup>49</sup> For detailed description of these institutional features in, see Anderson 2017. *Chinese debt capital markets: An emerging global market with Chinese characteristics*. SSRN working paper.

<sup>50</sup> People's Republic of China: Detailed Assessment Report: IOSCO Objectives and Principles of Securities Regulation, April 5, 2012, 8.

<sup>51</sup> Godwin, Andrew, Li Guo, and Ian Ramsay. "Is Australia's 'Twin Peaks' System of Financial Regulation a Model for China?" (2016), CIPR Paper No. 102/2016.

<sup>52</sup> Shu Zhang and Se Young Lee, China to merge regulators, create new ministries in biggest overhaul in years, Reuters, March 13, 2018.

Figure 3  
**Structure of the Chinese Bond Market**  
Source: CDCC

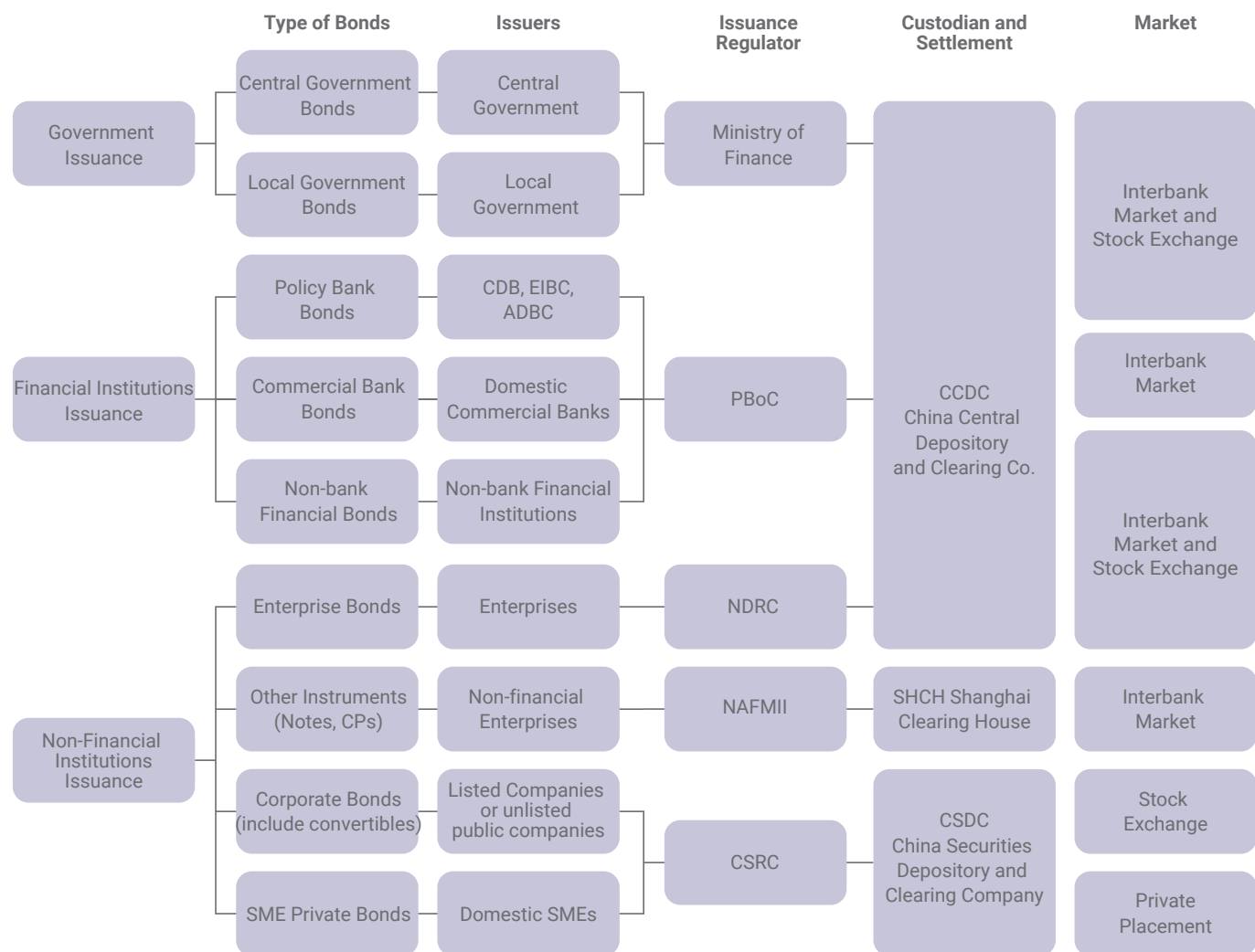
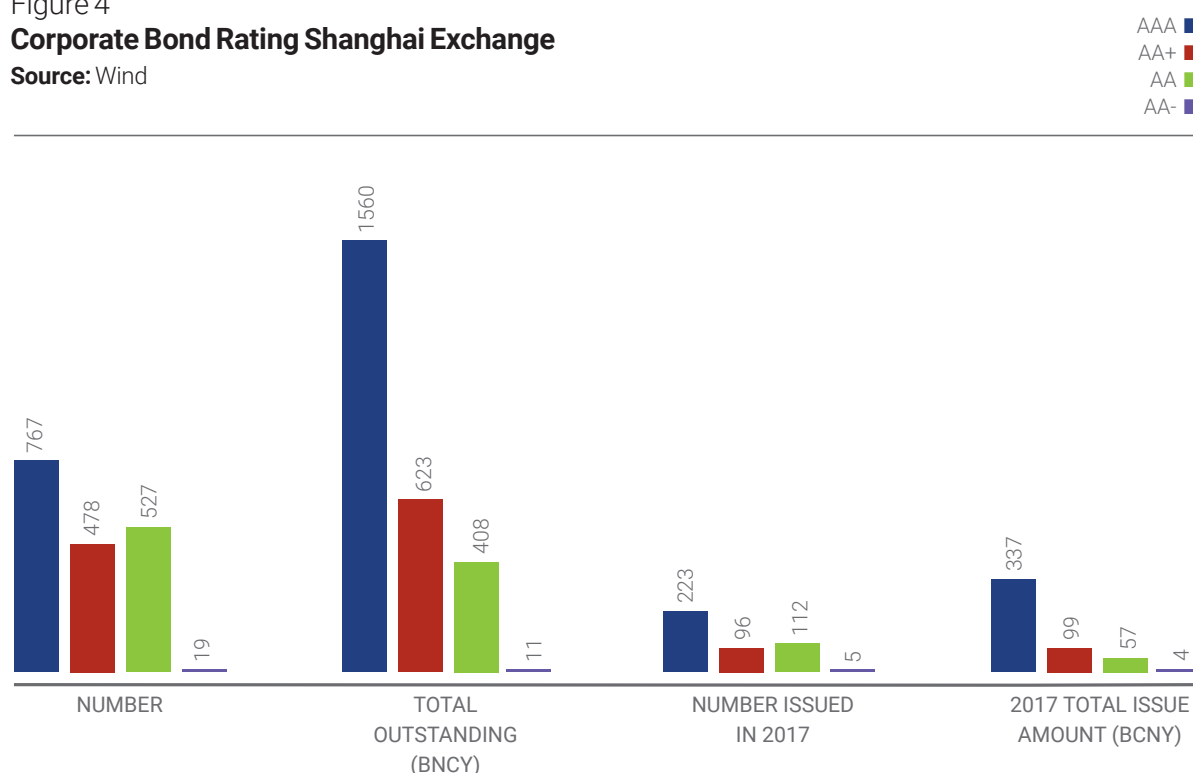


Figure 4  
**Corporate Bond Rating Shanghai Exchange**

Source: Wind



## REGULATORY COORDINATION

Godwin, Li and Ramsay (2016)<sup>53</sup> have given a detailed account of the history of regulatory coordination in China. In 2000, the PBoC, along with the CSRC and the CIRC held joint a conference with the aim of coordinating financial regulation (the '2000 Conference').<sup>54</sup> A subsequent joint meeting was held in 2003 when the CBRC replaced the PBoC and a memorandum of understanding was agreed, clarifying the '2000 Conference' (the 'Coordination Memorandum').<sup>55</sup> However, in reality, the joint meeting was not held until March the following year and no further meeting was held until 2013. This reflects the ad-hoc nature of the conference and lack of coordination plan.

In 2008, on the heel of the global financial crisis, the State Council issued the Regulation on People's Bank of China's Main Responsibilities, Internal Departments and Personnel Arrangements (the '2008 Regulation'), expanding the responsibility of the PBoC to include coordination among regulators and formulate rules for cross-sector financial transaction, instruments, and activities.<sup>56</sup> In addition, the 2008 Regulation established a Joint Ministerial Conference Mechanism led by the State Council with the PBoC, the CBRC, the CSRC and the CIRC as the members (the '2008 Conference'). However, under the 2008 Conference no meeting was ever held and the coordination arrangement remained at the high-level.

<sup>53</sup> Godwin, Andrew, Li Guo, and Ian Ramsay. "Is Australia's 'Twin Peaks' System of Financial Regulation a Model for China?" (2016), CIPR Paper No. 102/2016.

<sup>54</sup> Tian Junrong 'Three Main Financial Regulators Establish Joint Conference Mechanism', *People's Daily* (Beijing), 5 Sep 2000, 2.

<sup>55</sup> Nan Ke, Coordinated Mechanism Strengthens Financial Regulation' *Financial News* (Beijing), 19 Sep 2003.

<sup>56</sup> General Office of the State Council of the People's Republic of China, [Regulation on People's Bank of China's Main Responsibilities, Internal Departments and Personnel Arrangements] (14 August 2008) Government of the People's Republic of China [http://www.gov.cn/gzdt/2008-08/14/content\\_1072077.htm](http://www.gov.cn/gzdt/2008-08/14/content_1072077.htm)



In 2013, prompted by dramatic growth in complexity and interconnectedness of the financial markets, especially financial conglomerates and cross-sectorial financial activities, PBoC initiated 'the 2013 Conference', where members included three sector-based regulators and the State Administration of Foreign Exchange (SAFE). Furthermore, National Development and Reform Commission and the Ministry of Finance and other relevant agencies are invited to the meetings where necessary. After its initiation in August 2013, eight meetings were held over the next two years.<sup>57</sup>

However, the coordination efforts have been so far viewed as largely ineffective. This is due to multiple difficulties:

- 1) unclear delineation of responsibilities;
- 2) lack of regulatory power;
- 3) incompatible information sharing mechanism and inconsistent risk assessment systems; and
- 4) the ad hoc nature of coordination.

A member of the Standing Committee at the time, Wu Xiaoling has noted that several issues need to be addressed for 'the 2013 Conference' to work effectively. She specifically identified the need to

- 1) clarify the 'important problems' that need to be reported to the State Council in order to delineate responsibilities clearly; and
- 2) establish accountability mechanisms to ensure efforts are incentivised to implement the corresponding regulations.<sup>58</sup>

The following examples illustrate these difficulties.

In early 2004, the CBRC issued orders to stop banks from lending to security companies in order to quarantine banks from risks in the securities market because it was unable to effectively supervise the funds that were flowing from banks to security companies.<sup>59</sup> The difference in opinion among regulators and lack of common knowledge of lead responsibilities caused significant delay in shutting down NanFang Securities, established in 1992 and one of the oldest securities firms in China, which was allegedly involved in insider trading and manipulation of stock prices.<sup>60</sup> Financial conglomerates also land in the regulatory grey area and the existing legal and regulatory framework is insufficient for supervising their cross-sector activities and intra-group affiliated transactions. The collapse of the Delong Group, described as a 'quasi-financial conglomerate, or an industrial-commercial group with financial elements is a prime example.<sup>61</sup>

<sup>57</sup> People's Bank of China Financial Stability Analysis Group, 'China Financial Stability Report 2015', China Financial Publishing House, May 2015, 125-26

<sup>58</sup> Wu Xiaoling, 'Financial Regulatory Coordination System Cannot Remain in Name Only' (27 May 2014) *Wall Street Journal* <http://cn.wsj.com/gb/20140527/OPN112719.asp>

<sup>59</sup> Mo Fei, 'Joint Conference 'Reincarnates', 3 Main Financial Regulators in Difficult In-fights' *21 Century Business Herald* (Guangzhou), 5 July 2004.

<sup>60</sup> <http://finance.sina.com.cn/stock/y/20050312/09521424935.shtml>

<sup>61</sup> Fan Liao, 'Regulation of Financial Conglomerates in China: From De Facto to De Jure' (2011) 12 *European Business Organization Law Review* 267, 313, 294.



## 4.

# Practical Recommendations for China

Financial regulations have different objectives as the economy and the market grows and develops. The UK's financial regulatory regime inherits a strong British tradition of prioritising competition in markets, dating back to Adam Smith and his "invisible hand" argument. Above all, what the society needs is an efficient and stable financial system, and given the UK's history and tradition, this can be achieved by promoting competition.

China, on the other hand, has vastly different social traditions, political structures, and institutional settings from the UK; and most important of all, China is a transitional economy with an immature and fast-growing financial market. Consequently, market competition is unlikely the ultimate objective of financial regulators in China. Instead, regulation in China should aim to facilitate stable growth of the real economy.

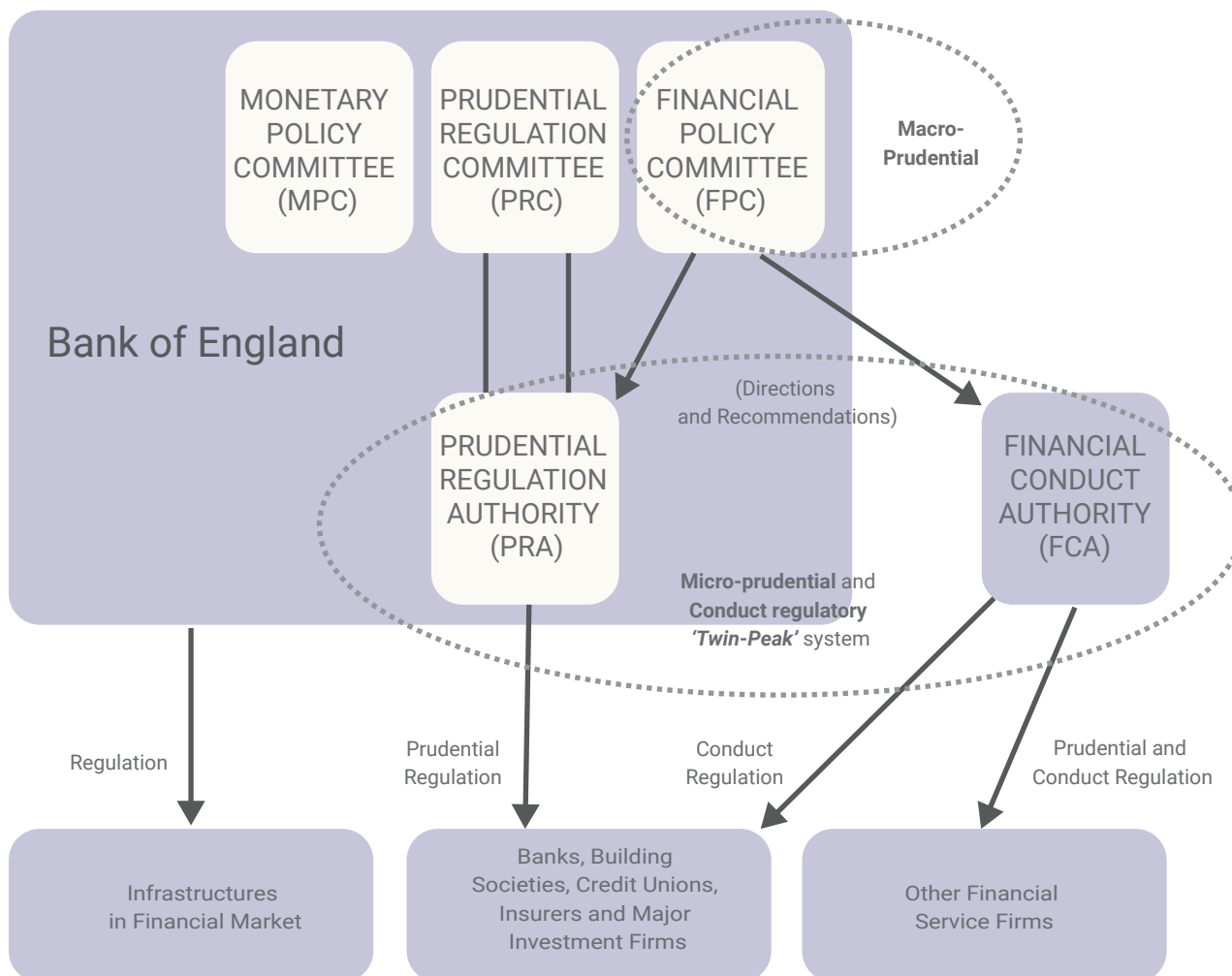
### STRUCTURAL DIFFERENCES

The Chinese system is more similar to the US system. That is, different regulatory entities are overseeing different markets. In the US: Securities & Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) regulate the securities and derivatives markets; Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC) along with the Federal Reserve supervise the banking sector;<sup>62</sup> National Association of Insurance Commissioners (NAIC) is the main regulator of the insurance industry. China also has separate regulatory commissions for the securities market, banking sector and insurance industry: China Securities Regulatory Commission (CSRC) and the newly merged China Banking and Insurance Regulatory Commission (CBIRC).

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<sup>62</sup> There are three federal regulators (FDIC, OCC, Fed), and there also are state regulators. The primary regulator depends on the bank charter.

Figure 5  
**The UK Financial Regulatory System**





Twin-peak is somewhat a misnomer in describing the UK's financial regulatory regimes. As described earlier and shown in Figure 5, it adopts some elements of twin-peak such as prudential (PRA) and conduct regulators (FCA) but also involves a "topping" which is FPC, a macro prudential regulator, and many "underwood" including the Treasury, and others. Also, the Bank of England plays a significant role in this regulatory regime. Unlike the rule-based regulatory system as in the US, the UK regulatory system is risk and principles-based and flexible in adopting to changing financial systems. Policy objectives are clearly specified for all involved with accountability. There is a strong coordination among monetary, fiscal and financial policy making bodies to ensure an effective institutional and governance structure to implement policies.

The advantage of having a dispersed regulatory regime is specialisation. Due to the intrinsic heterogeneity in their businesses, different sectors require different sets of skills and regulatory frameworks to achieve stability and efficiency. However, as markets become increasingly integrated, many financial conglomerates have activities across multiple market segments. The main advantage of having a uniform regulatory regime, such as the one in the UK, is the clear definition of regulatory responsibility and ability to regulate and efficiently manage the functioning of a sophisticated financial system.

For the longer term, some financial scholars have proposed to merge the regulatory commissions in China into one. Their functions should be consolidated and appropriately adjusted to specialist regulatory departments within the new regulatory entity. And instead of a functional-based regulatory regime, future regulation should be based on different objectives: stability, prudential, and conduct. In this report, we recommend that Chinese regulators look into the UK experience on risk-based and principles-based policy making. Although the design of the institutional structure deserves attention, this unique regulatory and supervisory style sets the UK regulatory system apart from others and makes it practical, flexible and adaptable to the changing environment. However, we focus on the following short-term goals in producing recommendations for reforming Chinese financial regulatory systems:

- 1. to adopt a somewhat similar risk and principles-based regulatory system, with Chinese characteristics, that very importantly remains flexible to new technologies and challenges; and**
- 2. to utilise the existing regulatory framework and achieve its maximal ability to regulate the growing financial system by designing a better coordination mechanism.**



## **DIFFERENCES AS TO REGULATORY OBJECTIVES**

Apart from the institutional and cultural differences, one key distinction between financial regulation in China and that in developed markets is the difference in priorities and objectives. As for China, a transitional country, the first-order concern is economic growth and political stability. This may, at times, lead to regulations and policies that undermine long-term financial stability.

The primary objectives of financial regulation in the UK are: a) effective market competition in the interests of consumers, b) consumer protection, and c) market stability. Financial regulation in China, on the other hand, focuses on economic growth and political stability. Take FinTech regulation for example: the FCA aims to nurture small and novel businesses to promote market competition, whereas Chinese regulators and policymakers are more concerned about market development and growth – they may even encourage market concentration should it promote growth.

Our recommendations will take these differences into consideration and propose practical and implementable policy changes to ensure the following three points:

- 1) that the fundamental prudential objectives are achieved;**
- 2) coordination among various regulatory agencies is maintained; and**
- 3) that the objective of high quality growth (but not growth at any price) is not compromised.**

For **point 1**, we propose that mandates for the UK's FPC could be used as a guidance for the newly created FSDC in China but with Chinese characteristics. For **point 2**, we highlight several channels for coordination for policy-making processes in the UK and propose similar processes for the corresponding Chinese institutions. For **point 3**, we suggest Chinese regulators consider adopting the 'learning ("to regulate") by doing' approach evidenced in FCA's Innovation Hub, market-based research technique. We also make other practical recommendations on the size and the funding sources of the regulatory agencies and supervision styles.

## RECOMMENDATIONS

### A Blueprint for FSDC with Chinese Characteristics

Given the UK experience, we recommend newly created Chinese Financial Stability and Development Committee (FSDC) under the State Council to adopt similar mandates and powers of FPC in the UK but with Chinese characteristics.

The FPC is the macro-prudential regulator in the UK. Its primary objective relates to “the identification of, monitoring of, and taking of action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system.” (Section 9c(2) Bank of England Act 1998). Its secondary objective is to exercise its functions with a view to ‘supporting the economic policy of Her Majesty’s Government, including its objectives for growth and employment.’ (Section 9C(1)) **We therefore recommend that Chinese FSDC sets up similarly primary and secondary objectives.**

UK FPC has the power to make recommendations to HM Treasury on the regulatory perimeter, and advise on which activities should be regulated and whether an institution carrying out regulated activities should be designated for prudential regulation by the PRA rather than the FCA and vice versa. Note that the UK experience is quite unique. A recent study of 41 bodies charged with financial stability around the globe has found only 11 of them have semi-hard and hard powers to direct countercyclical actions and only two, France’s High Council for Financial Stability and UK’s FPC, have hard powers over time-varying macroprudential tools.<sup>63</sup> **We recommend Chinese FSDC is mandated with these hard powers.**

More importantly, we recommend FSDC to have mandates and powers to address the negative feedback loop between real distortions and financial distortions, in addition to the potential issues existing only in the financial sectors. As a rapidly growing transitional economy, both real and financial distortions are present in the Chinese economy potentially creating

interconnecting consequences. This power will set the Chinese macro-prudential regulatory regime apart from existing regulatory models and pioneers a new approach to address financial stability in all transitional economies. To give a hypothetical example, the IMF 2018 FSAP report has identified that by awarding local government to achieve local GDP growth target, there might be a negative loop between local government excess risk-taking in infrastructure projects. This committee could commission a study to examine the extent of this negative feedback loop if it exists, and has power to implement policies to intervene and break this negative feedback loop if needed. This committee should have power to issue directives across different sectors, real or financial, if there are significant consequences for financial stability in the Chinese economy.

Besides a clear policy objective and hard legal power, the UK FPC also measures and monitors systemic risk. Together with the Bank of England, it conducts stress testing and produces the semi-annual Financial Stability Report. **We recommend a similar research facility to be established under FSDC and PBoC, coordinating with functional regulators, focusing on issues relating to systemically important financial institutions.**

Finally, we recommend **a strong role for FSDC to coordinate among multiple sector regulators, together with the PBoC.** The first is to make sure that governing boards for regulators have cross-over membership. As an example of how the FSDC committee might be structured: it could be chaired by a standing member of the Politburo and the PBoC governor also plays an important role. Its members could include deputy governors of PBoC that are in charge of exchange rates policy and financial stability, CBIRC, CSRC, Ministry of Finance, and external members.

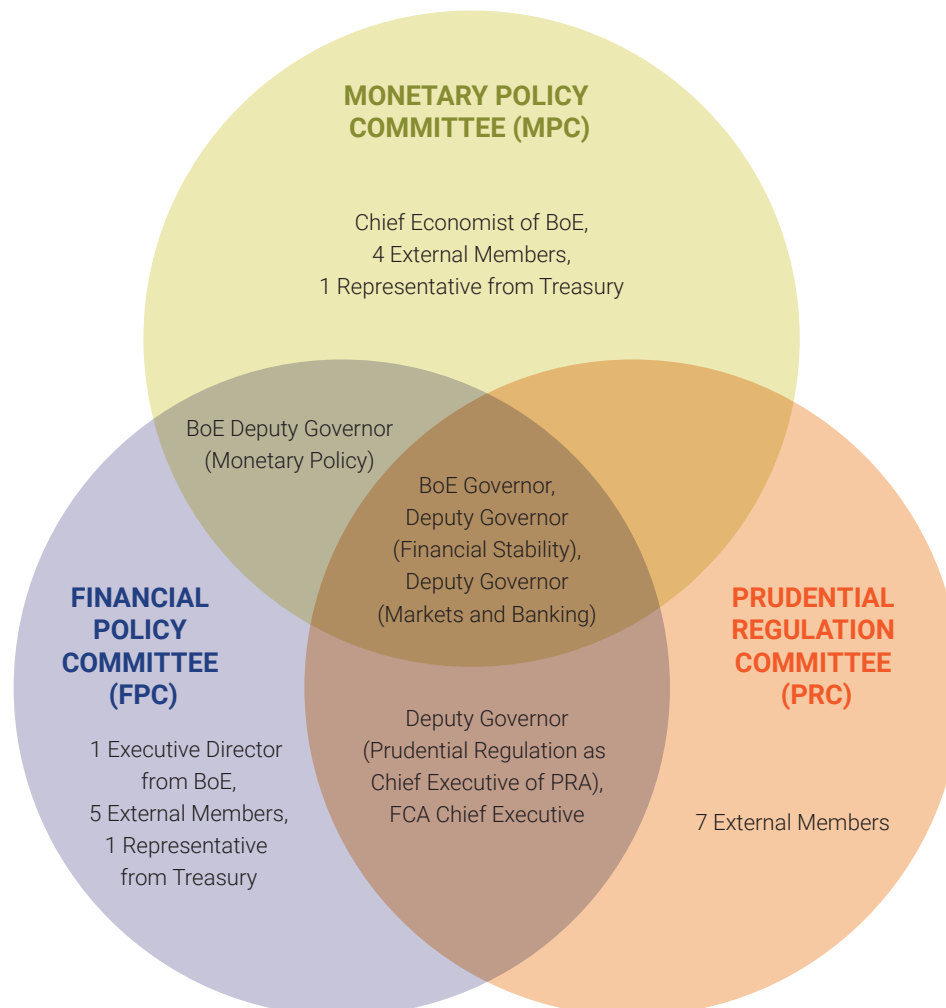
<sup>63</sup> Robert M. Edge and Nellie Liang New Financial Stability Governance Structures and Central Banks 2017 Hutchins Center Working Paper 32.

The following graph illustrates the membership across MPC, FPC, and PRC (PRA) committees under the BoE where all three committees have the same legal power and chaired by the governor of the BoE. Here monetary, macro prudential and micro prudential policy making are closely coordinated at the committee level. This might be a good reference benchmark to construct the membership of FSDC in China.

The second is to **establish MoUs for cooperation between all Chinese regulators**. In the UK case, FCA and PRA have signed five MoUs. Among the five, the MoU signed in April 2013 sets out how the FCA, the Bank of England and the PRA will cooperate with one another in relation to the supervision of markets and market infrastructure at every level.

Finally, **FSDC should schedule at least quarterly meetings among director-level officials across all regulatory agencies and PBoC**. This is to ensure communication and negotiation channels are continuously open.

Figure 6  
**Membership for MPC, FPC and PRC**



### Coordinating: Three Levels of Coordination

We recommend coordination at three levels: **1) coordinating rule making at the highest level; 2) coordinating on implementation, enforcement and supervision processes; and 3) coordinating on research.** We explain these three levels of coordination using the UK experiences and clarify specifics of our practical suggestions.

In the UK, the rule-making process between Treasury, BoE, PRA and FCA starts from FSMA which sets out primary and secondary objectives for PRA and FCA. The Treasury coordinates international engagements, and sets a yearly agenda via remit letters to BoE, PRA and FCA. MoUs are signed between PRA and FCA. There are quarterly meetings among FCA and PRA director level officials. Furthermore, there is coordination at FCA and PRA policy teams level. **We recommend that the FSDC should be the main regulatory body to implement and**

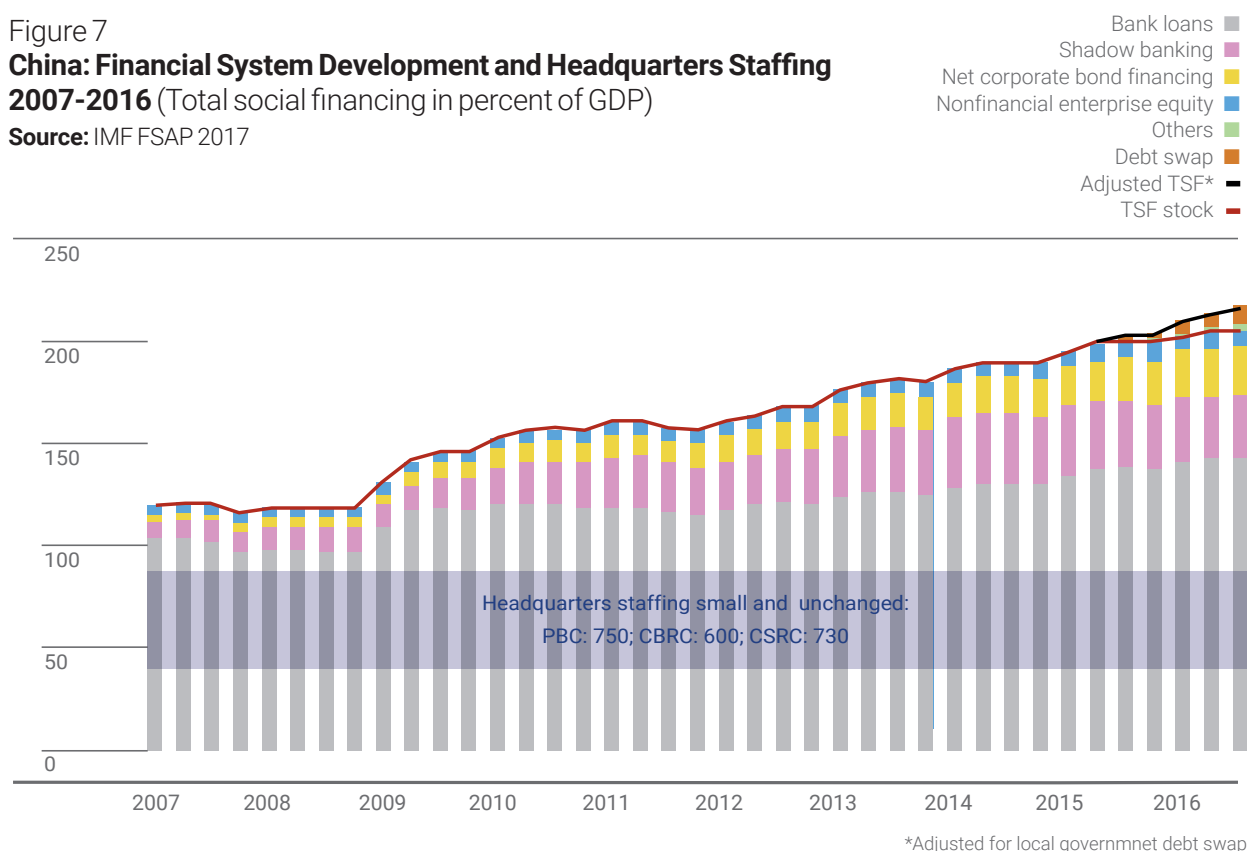
**oversee the highest level of coordination across PBoC, CBIRC, and CSRC.**

We also recommend coordination on implementation, enforcement and supervision processes. For example, PRA and FCA have to coordinate for those firms doubly supervised. In FCA, there are fixed portfolio teams for single industry firms but fluid portfolio teams for firms operating in multiple industries which require coordination among agencies. Whenever PRA or FCA implement rules relating to each other's secondary objectives, consultation and coordination across the relevant team will be triggered. **We recommend coordination among policy and supervision teams among PBoC, CBIRC, and CSRC when implementing new policy rules and enforcing regulatory penalties.**

**We also recommend a research hub coordinating information sharing and analysis among regulators in China.** In the UK, the BoE operates a research hub which coordinates research for FPC, PRA and MPC. Stress

Figure 7  
**China: Financial System Development and Headquarters Staffing 2007-2016** (Total social financing in percent of GDP)

Source: IMF FSAP 2017



testing parameters, for example, are set in a coordinated fashion across agencies. FCA also has a research team that produces market views to help regulators foresee industry trends and potential risks.

### **Balancing Growth, Innovation and stability: Learn from FCA's Innovation Hub**

In terms of balancing growth, and innovation with financial stability and conduct regulation, the FCA Innovation Hub initiative offers a possible response to a more general problem that is very relevant to the Chinese context.

This is the problem of how to tap the potential of financial innovations to increase efficiency and bring credit provision to credit worthy real investment projects that might otherwise go without funding, while at the same time learning what new risks such innovations can create. The FCA's sandbox is a relatively modest attempt to balance growth, innovation, and stability regarding FinTech, which affects an already established financial system. Whereas in China, the FinTech innovations could potentially disrupt and transform the existing financial system. Hence, a sandbox in the Chinese context could potentially be much more impactful since the regulators are able to not only learn about innovations as they emerge but also design new regulatory regimes to keep the financial risk in check, improve financial market efficiency and stability. **Specifically, we recommend creating a Research and Innovation Hub to achieve the following purposes:**

- creating a similar regulatory initiative to FCA's **Innovation Hub**. This initiative should involve officials from all three functional regulators as well as the central bank (as entrepreneurs may participate in any of these markets and new products may create new links across these markets).

- to set up a **regulatory sandbox** to facilitate financial product and service innovations. This approach to regulation is consistent with China's time-tested trial-and-error approach to economic reform, and is likely to receive support from the central government. A key issue is to identify a well-defined and self-contained market for testing innovative products – to maximise the effectiveness of the test while minimising adverse impact on the general public.
- to **create a market research institute under the PBoC** and all functional commissions, with a research hub coordinating the effort. This research institute will conduct scientific, objective market studies for all aspects of the financial market, with an emphasis on potential regulatory conflicts/vacuum under the current institutional framework.
- active **cooperation with international regulatory bodies and leading academic institutions**, both to share information and exchange ideas. They may organise annual forums/summits, involving regulatory officials, private sector leaders and entrepreneurs, as well as academic researchers from both within and outside of China.

The location of this Research and Innovation Hub deserves a further discussion. The working group of this report has considered FSDC to host this Hub due to the inherent advantage of FSDC in coordinating various financial regulators. However, FSDC is primarily a macro-prudential regulator. Giving it another growth and innovation objective might obscure its primary objective of ensuring macro-stability. Alternatively, this Hub could be administrated by PBoC together with all functional regulators, cooperating with the existing research centres within these administrative entities. This mechanism could reinforce the information sharing among regulators, but also require significant administrative and coordination cost.

## FCA Size and Income

The Financial Conduct Authority Limited (FCA) is a company incorporated in the United Kingdom under the Companies Act 2006, independent of the Government, and is a company limited by guarantee with no share capital. The financial statement also covers the Payment Systems Regulator Limited (PSR), a wholly-owned subsidiary of the FCA. It employs about 3,500 people, regulates the conduct of more than 56,000 businesses and is the prudential regulator for more than 18,000 businesses.

According to the most recent annual report in 2017, the total income is 574.9 million pounds, of which, 554.1 million is fee income and 20.8 million is other income, which mainly comes from the extra services that FCA provided, like Skilled Person reports. To finance the FCA's work, FCA charges fees to the firms they authorise and some other bodies such as recognised investment exchanges or registered firms.

There are mainly three types of fee:

- application, when the FCA is asked to authorise a firm;
- change to permissions, when a firm wants to change a permission for an authorised activity ;
- annual (periodic), which is payable each year.

Penalties constitute parts of the regulatory activity fees income.

FSMA enables the FCA to raise fees and the Financial Services (Banking Reform) Act 2013 enables the FCA to raise fees on behalf of the PSR, to recover the costs of carrying out their statutory functions. Fee income includes the annual periodic fees receivable under FSMA for the financial year and is recognised in the year and measured at fair value.

| Fee income   | Group               |                     | Parent Company      |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | Total<br>2017<br>£m | Total<br>2016<br>£m | Total<br>2017<br>£m | Total<br>2016<br>£m |
| Ongoing Regulatory Activity fees <sup>a</sup>                        | 513.1               | 507.1               | 502.9               | 479.0               |
| Ongoing Regulatory Activity fees – Consumer Credit (CC) <sup>b</sup> | -                   | 10.4                | -                   | 10.4                |
| Additional Ongoing Regulatory Activity fees                          | 5.5                 | 2.1                 | 5.5                 | 2.1                 |
| Scope change costs recovered – CC                                    | 7.7                 | -                   | 7.7                 | -                   |
| Scope change costs recovered – non CC                                | 10.2                | 2.8                 | 10.2                | 2.8                 |
| Application fees and the regulatory response <sup>c</sup>            | 9.4                 | 22.5                | 9.4                 | 22.5                |
| Special project fees   | 8.2                 | 0.3                 | 8.2                 | 0.3                 |
| <b>Total fee income</b>  | <b>554.1</b>        | <b>545.2</b>        | <b>543.9</b>        | <b>517.1</b>        |

<sup>a</sup> Of the £502.9m (2016: £479.0m) Ongoing Regulatory Activity fees, £46.3m (2016: £41.9m) related to penalties collected in the previous year for the sum of enforcement costs and returned to fee payers through reduced fees. See note 11 on Penalties

<sup>b</sup> 2017: Consumer Credit fees are now part of Ongoing Regulatory Activity

<sup>c</sup> 2016 figures for both group (£22.5m) and FCA (£22.5m) now include application fees and other regulatory income, previously disclosed as other income.



## Revenues and Resources

The IMF report has noted that the staff count at the headquarters of the PBoC and the regulatory agencies has not risen in 10 years, while the financial sector has doubled in size. For any regulatory and supervisory system to be successful, it is essential to have an adequate number of qualified staff to monitor increasingly complex and innovative financial products and services. Given the rapid growth of the financial industry in China, it has become increasingly urgent that the regulators expand their range and depth of skills before industry developments leave them unable to maintain meaningful oversight and authority (see Figure 7). The existing regulators are overburdened. For example, CBRC regulates four G-SIBS, and many mid-sized banks, and a very large number of small banks, and subsequently faces a heavy demand for its resources. CSRC faces the large presence of retail investors which requires a much more intensive approach to supervision compared to other large jurisdictions. The number of staff at the PBC and CSRC has not increased in line with new tasks and new market developments.

We recommend that Chinese regulators **consider following the fee-based revenue model of FCA to increase their budget autonomy in line with the growing financial industries**. We also recommend a **substantial research department** in addition to the policy and supervision department to be established under each regulator. The size of FCA (in terms of number of employees) dwarfs that of Chinese regulators combined. Out of its total 574.9 million pound income in 2017, 554.1 million is fee income. The fee structure is transparent and public. Fees are adjustable through public input. Other income includes special service fees and enforcement penalties. Giving regulators and supervisors budget autonomy that keeps pace with the financial industry will ensure that highly qualified staff will be retained and supervision of on-site and off-site financial services and products will be adequate and effective.



## 5. Conclusion and outlook

This report maps the regulatory set up introduced in the United Kingdom as a response to the recent financial crisis. It shows the institutional design with a particular emphasis on the question of whether regulation and supervision should be rather concentrated in an integrated supervisory structure, or rather shared amongst several bodies. While there is no one-size-fits-all solution, and while the institutional set up alone will not determine regulatory and supervisory effectiveness, it is a highly important question: regulator and supervisor provide the link between rule and market, theory and practice. Inefficient institutional set up has the potential to tame material rules even if they are good rules.

We found that balancing the advantages and disadvantages of sharing regulatory and supervisory functions over several bodies is at the centre of the question. Balanced regulatory objectives, clear institutional mandates and well-defined co-ordination and communication mechanisms are the means by which the inertia of a single, integrated regulatory can be overcome, while at the same time maintaining the relevant informational advantages.

We hope that this report will further the mutual understanding of the relevant issues and help with the further integration of the UK and Chinese financial markets. We further hope that this report can be the starting point for similar discussions between the UK and other transitional and emerging economies. This work could also be extended to the material aspects of financial regulation and supervision, such as enforcement styles, allocation of priorities and resources, and facilitated cross-jurisdictional access to financial markets.

Hence, we see this report as the starting point of a long and fruitful co-operation, covering many additional aspects.





## A FINANCIAL REGULATORY REGIME REFORM TEMPLATE TO ENSURE FINANCIAL STABILITY FOR CHINESE ECONOMIES

# Appendix

## Group Members

### Advisory Group Members

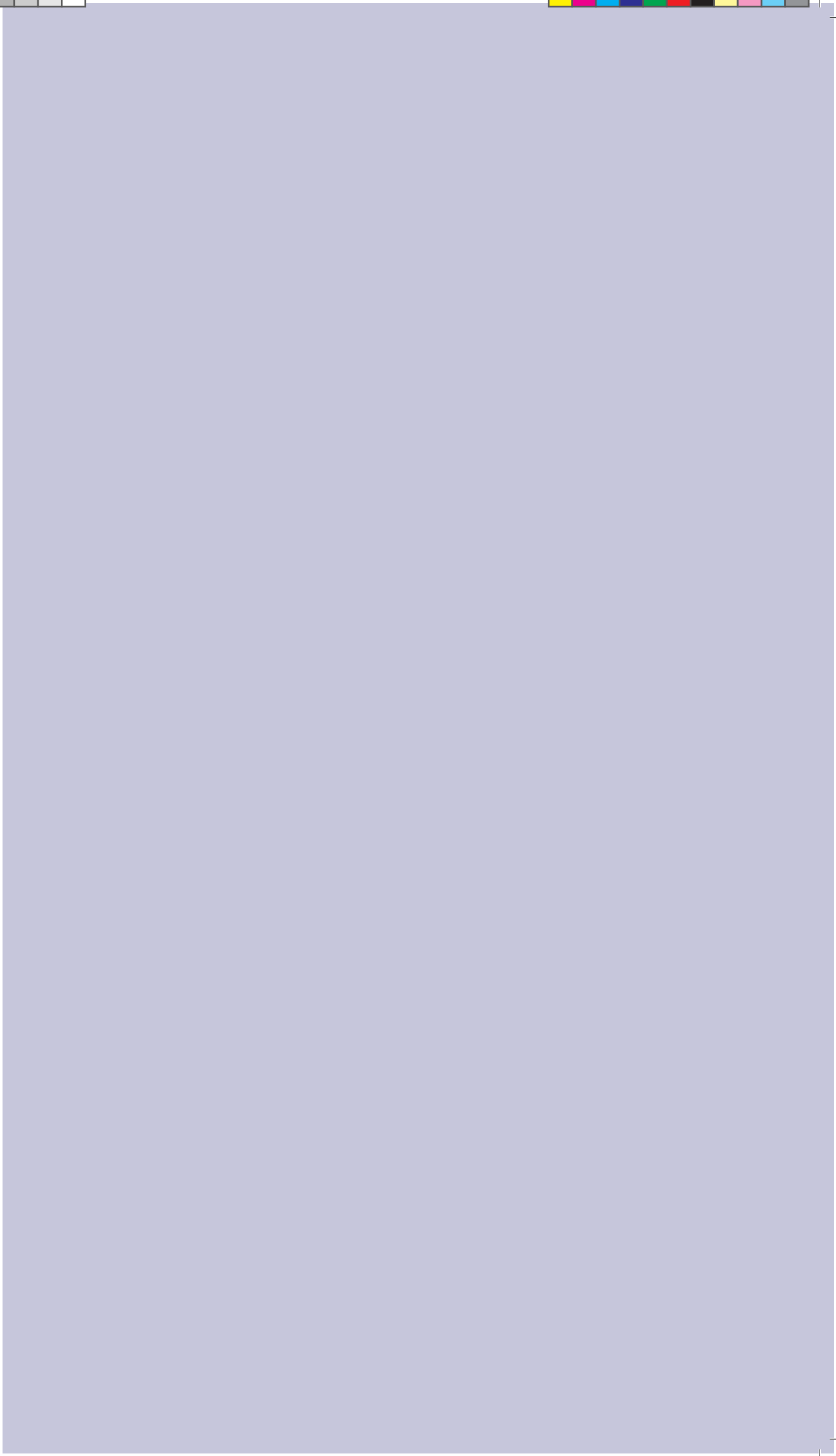
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