

Financial Regulation and Risk Management

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1. Human life involves assessing and managing risks; personal risks, family risks, organisational risks – to firms, public authorities and the voluntary sector, and risks to nations and groups of nations, such as the United Nations, N.A.T.O. and the European Union.
2. And these risks may be natural – volcanoes, earthquakes, floods, diseases – or social, arising from wars, revolutions, terrorism, booms and slumps, over-extended credit lines and asset bubbles, and from technological changes such as computers and the rest of modern IT.
3. One of the ways through which we seek to assess and manage risks of all kinds is through the use of money, with its ability to measure value, store value and serve as a medium of exchange. With money we buy insurance against a whole range of risks – illness, death, accidents and bankruptcy are some of them. And with money we adjust the surpluses and deficiencies of supply and demand to seek to avoid loss and to make profit. With money we create and acquire and destroy and dispose of assets; and with money we borrow and lend now in the hope, but not the certainty, of securing gains in the future.
4. Money, as the saying has it, makes the world go round.
5. Yet it is an imperfect instrument for assessing and managing risk – the use of money is a risk in itself;
 - inflation and deflation diminish and augment its purchasing power over goods and services and the value of the assets that it is used to measure;
 - boom and slump affect our willingness and ability to lend and borrow;
 - currency fluctuations impact upon the success and failure of our transactions with foreign countries;
 - criminals steal money in increasingly ingenious ways, taking advantage of technological developments in the handling of money;
 - and variations in the money supply, by governments and financial institutions, impact upon all the above factors.
6. Can we lay off for at least some of these risks?
The financial history of the last 200 years, and even longer, is, in effect, the history of trying to reduce these risks – and the method that we have increasingly employed is regulation in its various forms; financial laws, regulations and rules, and the setting of standards. Can we use regulation to take the risks out of using money?
7. We have certainly tried very hard to do so;

- commercial law regulates many aspects of financial activity; for example, what is to count as a valid contract;
- stock exchanges regulate the definition, and the buying and selling of many kinds of financial instruments; and commodity exchanges similarly regulate and define the sale and purchase of many commodities, such as wheat, coffee and diamonds;
- actuarial standards and guidance regulate and assess certain financial aspects of what the future may bring and suggest how financial provisions may be made for them;
- auditing standards regulate the assessment of certain financial aspects of past commercial and public activities, and suggest how their gains and losses may be determined and described;
- International Financial Reporting Standards set out the rules and regulations that must be followed in the preparation of financial statements for private and public authorities;
- codes of corporate governance seek to regulate – or at least outline by guidance – how companies, public authorities and other organisations – should determine their policies and their implementation;
- codes of ethics for professional conduct seek to regulate how members of such professions as law, accountancy, actuaries, medicine and such public servants as civil servants, NHS staff and local government officers, should comport themselves when engaged in professional activity.

8. Some of these regulations, rules and standards require strict compliance, for example, the law concerning liability for tax. Others allow for a measure of judgement within the boundaries laid down in a regulation, such as the accounting standard for revenue recognition.

9. And there is no doubt that the whole corpus of regulation in its various forms has taken many of the risks out of using money. Furthermore, as society develops new commercial and technological possibilities, these arrangements will need updating – indeed, it is with this that much of this conference is concerned. Thus in the current debate about international and domestic banking regulation consideration (1) is being given to what should be done about banks’;

- Capital requirements – and the ideas in the revised framework proposed by Basel II;
- Liquidity; where the Financial Service Authority have made proposals;
- “Too big to Fail”; where the government has required RBS and LBG to reduce branches and assets, and consideration is being given to the idea of “living wills” which would show how a bank could wind down in a crisis in an orderly way;
- Remuneration, Governance and Supervision; where Sir David Walker’s recent report is relevant (2);
- Disclosure and Accounting; where the current debate about “mark to market” valuations of bank assets has led to concern that the resulting asset value reductions might undermine confidence in banks in today’s fragile market.

10. Yet we face the paradox that the more aspects of risk that we seek to regulate or reduce, the more that we risk diminishing the opportunity for beneficial change and for economic and social advance. We might freeze what is currently seen as “best practice” into a procrustean bed of bureaucratic red tape; of endless audit, examination and oversight; of surveillance and the invasion of personal freedom; of the snuffing out of the human invention and creativity that has taken us from the stone age to where we are today.
11. As Franz Kafka and George Orwell showed, this would cost us all a great deal, and as we saw, it crippled the Soviet Union and led to its supersession.
12. Progress therefore demands that we should take risks. But which ones and how far?
13. I suggest that there are three principles to follow to achieve the balance between risk and regulation;
 - first, all participants in a range of activities need to understand the risks involved and act accordingly. For example we have seen in the recent work of Sir Christopher Hogg on the Combined Code (3), and Sir David Walker (op.cit.) on financial sector governance that the shareholder side of the capitalist system is not operating as responsibly and forcefully it should (4);
 - secondly, the network of regulations will need periodic re-examination and adjustment to take account of changes. Thus, as new financial instruments have been devised, such as the various forms of derivatives – credit derivatives, credit default swaps, collateralised debt obligations and others – it has become necessary to consider central clearing arrangements and margins and, for non standard derivatives, increased capital and collateral arrangements (5);
 - thirdly, in achieving the balance between risk and regulations, the maximum freedom should be allowed for:
 - judgements by individuals, rather than rule applications;
 - concern for the system as a whole rather than exclusive attention to individual financial institutions (6);
 - within the framework of constitutional and commercial law, for self-regulation, subject to independent oversight, by the sector concerned – accountancy, financial services, corporate governance, actuarial matters and so on – rather than control by external agencies such as central government or local authorities. An example of this approach is the oversight of the accountancy institutes and the actuarial institutes by the Professional Oversight Board of the financial Reporting Council.
14. The application of these principles involves risk itself and requires constant attention if they are to succeed. It must be remembered that no set of institutions can be expected to operate in a way that will inevitably secure the outcomes desired by those who have devised it. The results achieved come from a balance of forces between the individuals currently concerned, the events of the moment, and the circumstances described in

paragraph five above. Thus in the current debate about the roles of the Financial Services Authority, the Bank of England and the Treasury in banking regulation, there is no set of arrangements that can be guaranteed, or even be highly likely, to produce any specific result in detail in the long run.

15. The individuals required to make judgements as executives and regulators need accurate information – which is still difficult to secure – open communications, especially between firms and regulators; training, mentoring and experience at different points in their careers are all required.
 16. It is by the continued application of these principles in the way that I have described, that we stand the best chance of securing a balance between financial regulation and risk management; a balance in which we take risks to secure progress – but, like Wellington at Waterloo rather than Napoleon before Moscow, we know the risks that we are running!
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- (1) A useful survey of these issues is in “Evolving Banking Regulation” KPMG November 2009 and in Lloyd Blankstein “To avoid crises, we need more transparency”, Financial Times 13 October 2009
 - (2) Sir D.Walker “A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations” HM Treasury: November 2009
 - (3) “2009 Review of the Combined Code” Financial Reporting Council: December 2009
 - (4) See A.Hilton “Fund Managers face test over Cadbury”, Evening Standard: 1 December 2009
 - (5) See K.Griffin “We must overturn the status quo in derivatives”, Financial Times: 27 November 2009
 - (6) The case for a “holistic” approach to oversight is made out in Gillan Tett’s “Fools Gold”, Little Brown, 2009