Principles in Practice
An antidote to regulatory prescription

Report of the CSFI Working Group on Effective Regulation
CONTENTS

Foreword 5
Malcolm Williamson, Chairman of the Working Group

Preface: About the Working Group 7
Andrew Hilton, Director of the CSFI

Executive Summary 12

Introduction and Overview 16

Chapter 1: The Objectives of Regulation 23

Chapter 2: The Formulation of Regulation 31

Chapter 3: Implementation 43

Chapter 4: Enforcement 47

Chapter 5: Conclusion 54

Appendix 1: 56
Measuring the Problem; FSPP survey; Banking Banana Skins;
Open Europe: Selling the City Short.

Appendix 2: 62
Essays by: Howard Davies; Charles Goodhart; Stani Yassukovich;
Peter Wilson-Smith; Mick McAteer.

Appendix 3: 71
FSA: Extracts from speeches and reports.

Appendix 4: 84
Better regulation reports.

Appendix 5: 91
Mortgage template; APCIMS service description; examples of
good and bad regulation.

Cover and inside illustrations by Joe Cummings
The Centre for the Study of Financial Innovation is a non-profit think-tank, established in 1993 to look at future developments in the international financial field – particularly from the point of view of practitioners. Its goals include identifying new areas of business, flagging areas of danger and provoking a debate about key financial issues. The Centre has no ideological brief, beyond a belief in open and efficient markets.

Trustees
Minos Zombanakis (Chairman)
David Bell
David Lascelles
Sir Brian Pearse

Governing Council
Sir Brian Pearse (Chairman)
Sir David Bell
Geoffrey Bell
Robert Bench
Rudi Bogni
Peter Cooke
Bill Dalton
Sir David Davies
Professor Charles Goodhart
John Heimann
Rene Karsenti
Henry Kaufman
Angela Knight
Richard Lambert
David Lascelles
Robin Monro-Davies
Rick Murray
John Plender
David Potter
Mark Robson
Sir Brian Williamson
Peter Wilson-Smith
Minos Zombanakis

Staff
Director – Andrew Hilton
Co-Director – Tim Jones
Senior Fellow – David Lascelles
Programme Coordinator – Sam Mendelson
Working Group Coordinator - Sandi Veerabudren
Editorial Assistant - Kerry Thompson

CSFI publications can be purchased through our website http://www.bookstore.csfi.org.uk/
or by calling the Centre on +44 (0) 207 493 0173

Published by
Centre for the Study of Financial Innovation (CSFI)

Email: info@csfi.org.uk
Web: www.csfi.org.uk

© CSFI 2007
This publication is in copyright. Subject to statutory exception and to the provisions of relevant collective licensing agreements, no reproduction of any part may take place without the written permission of the Centre.

Printed in the United Kingdom by Heron, Dawson & Sawyer

Mention financial services regulation and the temperature rises, depending on your role. This working group had a membership of industry practitioners and trade association representatives, but also a cross section of politicians, consumer representatives and university professors.

Our conclusion was that many parties are associated with the perceived problem of over-regulation. The industry itself invites regulation if it either behaves unprofessionally or demands too many detailed prescriptive rules to guide it. Governments can be to blame if they do not invest enough time heading off regulation from overseas, or influencing its direction at an early stage. They can also be guilty of trying to regulate when it may not be necessary or of being over elaborate in the legislation and its implementation, as the US has been with Sarbanes-Oxley.

The global burden of regulation is now the biggest issue facing cross-border financial groups. Not only do they face huge costs in implementing new regulations to tight deadlines, but the regulations themselves are often hard to reconcile. Different countries, and different regulators, still do things differently. In the absence of a global gatekeeper (from where would it derive its authority?), the importance of initiatives to co-ordinate regulatory activity cannot be stressed enough.

Smaller firms feel the weight of cross-border regulation particularly keenly, especially in the European Union where implementation of the Financial Services Action Plan is in full flow. On the retail side of the business, heavily populated by small firms, the desire of government and regulators to be seen as consumer champions can lead to knee-jerk responses. This can pile on regulation either unnecessarily or in a disproportionate and poorly targeted way.

The UK has a population that is not very financially literate. Documentation for products is often too complicated and does not spell out suitability for the client, the risks, the costs and the commissions paid to distributors, including independent financial advisers.

All this led the Regulatory Working Group to ask a number of questions, including:

- how can we head off over-zealous regulation – particularly when it comes from non-national regulators (the EU, Basel etc)? and
- how can we ensure that out-of-date regulation is reviewed and scrapped if necessary?

We also addressed the problems posed by having a single regulator, like the FSA, that squeezes both wholesale and retail regulation under one roof. These problems, which are fundamental to the UK, include how to maintain (indeed, encourage) two different regulatory cultures within a single organisation.

For the most part, it is agreed that wholesale regulation works better than retail in the UK – and, therefore, most of the focus of this report is on the retail end. There, the key questions addressed include:
how to make principles-based regulation, which the FSA is rightly pursuing, work in practice, bearing in mind the need for more prescription and guidance in retail markets than in wholesale;

how to embed both industry knowledge and the understanding of what consumers want into all stages of the regulatory process;

how to effect the cultural change necessary in the principles-based approach, which entails a higher degree of trust on the part of the regulator and more responsibility and better leadership on the part of regulated businesses; and

how to build a set of minimum standards to supplement principles – and, at the same time, reduce the existing rule book.

Working through the lifecycle of regulation, from its initiation to its enforcement, we felt it was worth highlighting the need to remember the few fundamental justifications for regulation and that it should be a last resort. Although the FSA is seen as the “single regulator” there is a risk of overlap – the Office of Fair Trading’s remit is to look at fairness of pricing, the Ombudsman is there to opine on individual cases, while the FSA looks at systemic issues. This raises such questions as:

- how the ombudsman can be encouraged to refrain from looking for systemic problems rather than the appropriateness of individual treatment; and
- how the government can be convinced not to widen the FSA’s remit still further when it has challenges aplenty.

Moving on to regulatory implementation, we started from the premise that the tendency to add to legislation at this stage should be strongly resisted. The key issues include:

- how to stop national regulators adding inappropriately to supra-national rules; and
- how to repeal national regulation that has been superseded by cross-border rules.

On enforcement, we believed that the move to more principles-based regulation needed to be backed up by strong deterrents for those who break the spirit of the law, as well as the letter of the – much reduced – rulebook.

All of these are valid issues and the FSA is tackling many of them. Our Regulatory Working Group does not have all the answers, but we hope that our suggested remedies will stimulate debate.

And finally, we would like to thank the FSA for all its help in the compilation of this report.

Malcolm Williamson
Working Group Chairman
PREFACE:
ABOUT THE WORKING GROUP

The motivation for this report came from within the CSFI, in large part as the result of successive Banking Banana Skins surveys, which have identified over-regulation (and excessively prescriptive regulation) as the major risk facing the banking industry today. That may seem odd; after all, regulation may be a cost, but is it really a risk?

Well, BBS respondents in 2005 and 2006 clearly felt it was. It takes management’s eye off the ball; it undermines the principle of caveat emptor; it adds another layer of charges that drives business to unregulated competitors. And, of course, from a narrowly nationalistic point of view, it can disadvantage one financial centre (be it New York or London) over another.

And there is no force pushing back – particularly within a single, monopoly regulator where the bureaucratic imperative is to make sure nothing goes wrong on one’s own watch. The FSA can talk all it likes about not operating a zero failure regime, and MPs can say the same thing. But there is not a journalist or a politician in the land who would not lay into the FSA (and all who sail in her) if/when the next Barings is uncovered – or the next precipice bond scandal, or whatever. In a very modest way, we would like to provide a little regulatory push-back.

The working group’s mandate was to produce an intellectually honest case for less (and less intrusive) regulation, for lighter-touch regulation (though the regulator hates the phrase) and for more reliance on industry initiatives and the market itself. Members of the group were deliberately invited to represent a range of interests. They included senior figures from the wholesale and retail sides, from consumer groups, from the regulatory community, from Westminster and from academia and the press. Not everyone participated in every meeting, and not everyone in the group will subscribe to every recommendation in the report – which is why we have included articles in which dissenters explain their views. However, we are enormously grateful to all those who did participate, and who reviewed this report at each stage. We are particularly grateful to Malcolm Williamson, chairman of NAB Europe (and a former CEO of Standard Chartered and Visa), who chaired the group with immense wisdom and integrity.

I would also like to record my gratitude to Jane Fuller, the former financial editor of the Financial Times, who laboured long and hard as the group’s rapporteur – though her role was much more than that. The fact that the report is a good (and elegant) read is largely thanks to her – with a valuable helping hand from my colleague, David Lascelles.

All in all, the working group was an impressive body, which reflected a wide range of views on the role of financial services and its regulation. It included:

Henry Angest, Chairman and Chief Executive of the Arbuthnot Banking Group and Chairman of the Banking Committee at the London Investment Banking Association.

Mark Boleat, a company director and consultant specialising in regulatory issues. He was formerly Director General of the Association of British Insurers (ABI).
Richard Britton, a consultant on European regulatory matters for the International Capital Market Association. He previously worked in capital market policy for the Financial Services Authority and bond sales at Merrill Lynch.

Michael Buckley, a non-executive director of M&T Bank Corporation, a large US regional bank, senior adviser to Freeman and Company, a specialist New York-based investment bank, and adviser to Irish and international companies. He retired as Group Chief Executive of Allied Irish Banks in 2005.

Clive Cowdery, Chairman of Resolution plc and Chairman of the not-for-profit organisation, The Resolution Foundation. He was previously Chairman and Chief Executive of GE Insurance Holdings.

Mary Francis, a non-executive director of Aviva and Centrica and former DG of the ABI. She previously worked in the Treasury and as private secretary to Prime Minister John Major, and deputy private secretary to the Queen.

Jane Fuller, Director of Fuller Analysis, advises companies on media and investor relations. A former Financial Editor of the Financial Times, she is now Consulting Editor to Financial World.

Mark Garvin, Chief Administrative Officer – International for Treasury & Securities Services at JPMorgan. He is Chairman of JPMorgan Europe Ltd and Chairman of the Supervisory Board of J.P. Morgan AG. He is also Chairman of the Association of Foreign Banks and a Director of Euroclear Plc.

David Gauke, Conservative MP for Hertfordshire South West and a member of the Treasury Select Committee. He formerly worked as a solicitor for Macfarlanes.

Charles Goodhart, Professor Emeritus of Banking and Finance at the London School of Economics. He was a member of the Bank of England’s monetary policy committee 1997-2000, and is co-founder of the LSE’s Financial Markets Group.

Andrew Hilton, director of the CSFI. He is a former World Bank economist and Editor in Chief of the International Reports Group in New York. He also runs an economic consulting firm in London.

Chris Huhne, Liberal Democrat MP for Eastleigh, and a former MEP and economic and finance spokesman of the European Liberal group in the European Parliament.

David Lascelles, senior fellow and joint founder of the CSFI. He spent 25 years at the Financial Times where his senior posts included: New York Correspondent, Banking Editor and Resources Editor.

Mick McAteer, an independent consumer advocate. He was formerly Principal Policy Adviser at the consumer organisation Which?

Robin Monro-Davies was Chief Executive Officer of Fitch Ratings until his retirement in 2001. He is currently a non-executive director of HSBC Bank plc, AXA UK plc, AXA Asia Pacific Holdings Limited and Assured Guaranty Ltd., as well a number of private equity and smaller companies.

Sir Adam Ridley, Chairman of the Equitas Trust. He was formerly Director General of LIBA and special adviser to Sir Geoffrey Howe and Nigel Lawson at the Treasury, and a member of the Council of Lloyd’s and the Lloyd’s Regulatory Board.

Malcolm Williamson, Chairman of CDC Group plc, National Australia Group Europe Limited and Signet Group plc and Deputy Chairman, Resolution plc. He is also non-executive director of Group 4 Securicor plc and JP Morgan Cazenove Holdings, and a member of the Board of Trustees of The Prince of Wales International Business Leaders Forum.

Peter Wilson-Smith, a director of Quiller Consultants, one of the UK’s leading strategic communications consultancies. Before joining Quiller, Peter was Editor-in-Chief of Financial News.

Stanislas M. Yassukovich, non-executive chairman of Prometheus Energy and Park Place Capital, and former chairman of Merrill Lynch Europe and Middle East.
I would also like to thank the institutions that underwrote the report. Without their help, the group could have achieved nothing. They include:

- Resolution plc
- National Australia Group
- International Capital Market Association
- JPMorgan Chase
- Arbuthnot Banking Group
- Winterflood Securities
- ABC International Bank
- Close Brothers Group plc
- Morgan Stanley
- Henderson Global Investors

Resisting the siren-song of over-regulation is a tough task. In many ways, the FSA has been a model of good intentions - saying the right thing and, not infrequently, following up. But the pressures to strangle the life out of the City are hard to resist - not least because Parliament, Brussels, many consumer activists and most journalists are all looking for a stick to beat the regulators with if anything goes wrong. I hope that we have provided a bit of ammunition to those who think it is important to fight back.

Andrew Hilton
Director, CSFI
The downside of regulation

All regulation is bad – but it may well be necessary. However, the fact that it may be necessary should not obscure the fact that it is, in itself, a bad thing.

Why is regulation so bad?

First, it is not a free good – something that seems to slip the mind of many journalists and most politicians. Indeed, it can be very expensive — and its cost is spread over every financial product that is sold in the UK. At a time of double-digit returns, that may not appear so onerous. But in an environment of low inflation and low real returns, the cost of regulation can be devastating over the entire life of a long-term savings product. The power of compound interest can work to cut returns, as well as increase them.

These costs are not easy to get a handle on. They do not only include the fees that are payable by regulated institutions to their regulator. Indeed, those have been fairly stable since the Financial Services Authority was set up, at least in real terms. They also include:

• the fines that are imposed, often for quite trivial “offences” that are actually brought to the attention of the regulator by the firms themselves; and, more important
• the incremental cost of compliance with FSA-mandated regulations.

Compliance can be a bottomless pit. The compliance function is the fastest growing part of the UK financial services industry – but it is slippery. How many of those compliance officers (and lawyers) does a firm really need? And how many are foist on it by otiose regulation? The FSA hasn’t really been able to answer the question yet. Depending on the sector, it could be anything from 0.5% of total costs to 37% – which is too broad a spread to be helpful. And don’t expect the firms to volunteer the information either. After all, it is not in a compliance officer’s professional best interest to badmouth his own job. Quite the contrary.

Nor is it in a regulator’s interest to underplay the need for regulation. No regulators, at any level, have ever felt that their careers would be enhanced by having a firm go belly-up on their watch. This means that – although the FSA has said all the right things about not operating a “zero-failure regime” – the reality is that line regulators are doing their best to make sure nothing happens that can reflect badly on them. And that means a general disposition in favour of more micro-prudential regulation, more regulators and less forgiveness – all of which drives up the cost.

It gets worse. While everyone accepts that, in principle, a regulatory regime in which there were no failures would be a disaster, there isn’t a politician or journalist in the land who could resist the temptation to dump on the FSA if, say, another Leeson were discovered beavering away in the bowels of one of our biggest banks. As a result, there is something akin to a conspiracy in favour of progressive over-regulation – and anyone who advocates “pushback” risks being stigmatised as irresponsible.

And don’t expect the banks to fight this. The reason is that, for them, regulation is another row of bricks on the wall that protects them from the healthy wind of competition. At least for retail institutions, the cost of regulation can usually be passed on to customers – while the regulations themselves are a massive barrier to entry, jacking up the entry fee for anyone who wants to challenge incumbents.
Regulation also favours the big and discriminates against the small. Most of the costs of regulation are fixed, and can be spread more thinly over a larger customer base. For smaller institutions (the ones we want to encourage if we are to have a healthy, growing financial sector), the unit cost of regulation is much, much higher.

This may not matter on the upswing of the business/banking cycle (which is where we seem to have been for aeons). But cycles turn; and when profits are lower, smaller institutions will really find the burden of regulation, in terms of fixed costs, a major problem. Many will go to the wall – driven there, ironically, by regulations that (in many people’s eyes) are intended to protect them.

And, of course, regulation inhibits innovation.

This is not quite as straightforward as it sounds, since one can make the case:

- that what the UK financial sector (and, in particular, the financial consumer) suffers from is too much innovation, not too little; and
- that this is one of the very few industries where the consumer interest would be better served by less competition, not more.

Nevertheless, it seems axiomatic that putting every new financial product (at least in the retail area) through endless regulatory hoops means that some good ideas will be strangled at birth.

Regulation can also hurt the consumer. Even short of gross over-regulation, it has two consequences that are insufficiently appreciated:

- First, it undermines the principle of caveat emptor – it encourages the negligent to exploit protections that were aimed at the vulnerable. The result is to make an already litigious industry even more so.
- Second, as noted, it reduces the return that we can expect on the savings or investment products that we buy from regulated entities. That may not matter so much if we are just buying, say, one-time travel insurance. But many savings products have 20 or 30 years lives – and the return is cut every year by the cost of regulation.

On top of all this, we must also be wary because regulation has a tendency to migrate – in particular, to migrate from the retail sector (in which it may well be an unavoidable necessity) to wholesale and inter-professional markets, where both sides of a deal know how to look after themselves.

This is an important point because it is counter-intuitive. There is a temptation to say that, if it is right to regulate the doorstep lending market (which is pretty small beer), it must a fortiori be even righter to regulate the FX market, which shifts trillions of dollars a day through the market. Not so: it is important that the regulatory spend should be focussed on those who cannot look after themselves, not those who can – particularly since wholesale and inter-professional markets are perfectly capable of decamping overnight for a more hospitable environment if the regulatory burden becomes too great.

Andrew Hilton
EXECUTIVE SUMMARY

Concern about over-regulation of the financial services industry in the UK is growing, as evidenced by several surveys in recent years that have highlighted the huge volume of new regulation and its intrusive style – and the costs these impose on business.

In early 2006, the Centre for the Study of Financial Innovation assembled a working group of financial practitioners and observers to consider the problem and propose recommendations to make the regulatory process less burdensome – without compromising customer protection.

Starting with the objectives of regulation, the group followed the regulatory lifecycle through formulation and implementation to enforcement. The aim was to see, at each stage, what approaches or structures might help to simplify and improve the outcome.

The objectives of regulation

The fundamental objectives of financial regulation should be:

- To prevent systemic failure;
- To encourage efficient markets;
- To provide consumer protection.

Formal regulation should be a last resort. Since haste, or a failure to check what rules and penalties already exist, is often a source of poor regulation, the legislator should describe the failure that a new measure is addressing and state why existing rules are inadequate. The remedy may lie in improving detection or imposing heavier penalties. Where a fresh initiative is deemed necessary, a statutory response should be the last resort: the regulator should state why other solutions – market-based or emanating from the industry – would not work.

The benefits should outweigh the disadvantages. Even if a theoretical case can be made for regulation, the benefits should outweigh the costs. Regulation is an expense borne directly by businesses and indirectly by their customers. So, however imperfect the methods, the onus is on the regulator to justify the investment in new measures.

- Regulation should always undergo an independent cost-benefit analysis (CBA), or impact assessment. This is already required of the UK’s Financial Services Authority but methodologies need to work better.
- There should be more retrospective evaluation of regulatory costs to identify areas needing reform and to assess the accuracy of earlier CBA.
- Where it is impossible to quantify costs and benefits, the regulator should explain why it nevertheless thinks that regulatory action is essential.

Regulation should be based on principles. Every regulator should have a small number of durable principles (the FSA has 11). Little is new in human wickedness, so why is there need for new laws? Principles should provide a litmus test for behaviour when there is no specific rule banning it.

- It should be clear under which principle each new rule falls.
• To emphasise the principles, regulators should pursue the option of prosecuting on the basis of breaches of principle alone.
• Boards are responsible for ensuring that their companies follow the principles.
• To help businesses comply, regulators should be prepared to give guidance on what is in line with the principles and what is not.
• Regulatory staff should have the expertise – and be motivated – to exercise greater judgment and common sense so as to minimise the burden on business.

Formulation of regulation

From principles to minimum standards. Since principles alone are insufficient, they should be complemented by minimum standards. The need for such standards is greater on the retail than the wholesale side and the separation by the FSA of its wholesale and retail business units acknowledges the call for different regulatory approaches.

• The mandatory part of regulation, whether it be retail or wholesale, should take the form of minimum standards.
• The wholesale unit should be encouraged to have a different culture from its retail counterpart so as not to compromise its preference for market-based solutions.
• Regulation of retail business will inevitably be more detailed and prescriptive.

A proposal for structural reform. More effective regulation of the retail business could be delivered by an approach that embeds market participants – buyers as well as sellers – in the regulatory process. This approach should be based on industry sectors, helping to ensure that regulatory teams are both knowledgeable and easy to do business with.

The sector bodies would recommend minimum standards to the FSA for endorsement so that it continues to fulfil its role as the legally designated regulator. Firms complying with the standards would have a safe harbour from prosecution, although individual cases would still go to the Financial Ombudsman.

Since it is easy to talk about minimum standards but difficult to combat the urge to add requirements, practical guidance is offered.

For products and services:

• Standards should require a short, clear description of what the product is, who it is aimed at, the risks and the charges.
• Particular attention should be given to the explanation of risk. For some product families a voluntary system of risk rating or labelling might be helpful.
• Consumers should be willing to sign “I have read and understood” statements.
For sales:
There should be absolute clarity on commissions and other charges as part of simple product descriptions. Further:

- Independent financial advisers (IFAs) should act unequivocally as the agent of the client, not the provider. The way the IFA is remunerated must reflect that.
- IFA examinations should be reviewed by the standards setter.
- Product providers should conduct after-sales follow-ups on a sample basis.

Implementation

It is often during the writing of measures to implement legislation that prescription and complexity are increased. This introduction of extra elements is sometimes known as “gold plating”. Accretions to original legislation come in four main forms:

- domestic regulators adding to rules set by a higher, or cross-border, authority;
- national or international codes of practice, developed by independent bodies;
- voluntary industry codes;
- self-imposed additions by individual firms worried about compliance.

Not surprisingly, the working group was generally opposed to gold-plating and believed it should be combatted from two sides:

At national level:

- National regulators should not add compulsory requirements to rules set by supra-national authorities. The guiding light should be what is best for cross-border business not what justifies the existence of domestic regulators.
- National rules that are superseded by new cross-border ones should be repealed.
- Cross-border legislation that would harm UK business must be fought at a political level in Brussels, or wherever else it emanates from.
- The UK should beware of imposing verification requirements or enforcement procedures other than those required in directives or other internationally agreed regulation.
- Where the UK has developed a guide to best practice, such as the Combined Code on Corporate Governance, it should be voluntary.

At industry level:

Companies and trade bodies must beware of becoming part of the problem by inviting more detailed and prescriptive regulation in their search for certainty of interpretation. They should also:

- Treat advice from experts as just that – to be accepted or rejected as risk assessments that inform, but do not inhibit, development of the business.
- Resist the temptation to protect vested interests or discourage competition.

Enforcement

Less is more. The FSA’s “risk-based” approach to regulation has delivered fewer but bigger financial penalties, and been accompanied by a move towards prosecution on
the basis of principles alone. This is welcome. But there need to be checks on the use of “principles alone” enforcement:

- Predictability: reviews of conditions prevailing at the time must have a strong independent element.
- Where possible, breaches of specific rules should be cited as well as principles.
- Transparency: reasons for action on the basis of principles alone should be published along with contrary arguments.
- The Financial Services and Markets Tribunal should review enforcement actions on the basis of principles alone, with a view to publishing lessons to be learnt.

The separation of powers. The Regulatory Decisions Committee, part of the FSA, takes significant enforcement, authorisation and supervisory decisions. Its independence was enhanced after the Strachan review but further reforms might include:

- allowing it more latitude to raise questions about FSA policy;
- housing it in a different building;
- ensuring that the chairman leads a fully independent appointment process;
- requiring that more RDC members have recent, operational business experience.

Reducing intrusive supervision
Complaints from financial firms focus on the volume of regulation, the regulator’s demands for documentation, and the need to obtain guidance – despite the FSA’s proclaimed move towards principles-based regulation. The FSA should encourage a switch from the routine to the important, which will entail raising the quality of its processes and staff – on which it is making a start.

- The FSA should continue to refine its risk assessment process. Cutting routine supervisory work should enable it not only to trim staff numbers but to switch better informed staff towards the provision of advice.
- More emphasis should be placed on investigating suspicious activity, following up complaints and mystery shopping on behalf of consumers.
- Regulators should aim to nip problems in the bud by giving firms advice or issuing public warnings.

The way forward
Since the CSFI working group was set up, the FSA has moved to tackle widespread concern about the over-burdening of business. Its emphasis on principles-based regulation (and prosecution) is one example, and recent moves to cut the Handbook and ease rules on the sale of general insurance products are also welcome. Its freedom to mitigate the burden is, of course, limited by the international nature of much regulation. But scope for further improvement lies in a more streamlined structure, the handling of regulation in a manner that is sensitive to the dangers of excess, and continued emphasis on principles-based regulation backed by high quality staff.
Too much regulation

Ask a senior banker in Europe 10 years ago what he thought was the biggest risk facing the financial sector and he would have said “poor management” – a risk he could do something about. Ask him the same question today and the answer is: “too much regulation”. Those have been the conclusions of the annual Banking Banana Skins surveys run by the Centre for the Study of Financial Innovation (CSFI).

In his foreword to the 2006 report [see appendix 1], John Hitchins, UK banking leader at PricewaterhouseCoopers, which provides financial support for the survey, said: “At the heart of this is frustration with the growing cost and complexity, and the diversion of management time.” Respondents talked of “the explosion” of laws and regulations and a “drain on resources” that “could cause firms to take their eye off the ball and miss something important”. It was not only new rules but “the intensity with which they are applied” that concerned respondents. They commented on the “increasing aggression” of regulators, prompted by political pressure to increase consumer protection.

The problem is particularly acute in Europe, where the weight of 42 measures in the EU’s Financial Services Action Plan (FSAP) has come on top of other international and national regulatory activity. Even regulators recognise that there can be too much change. The UK’s Financial Services Authority (FSA), in its 2007 Financial Risk Outlook, says: “The relatively high level of regulatory change, brought about in large part by the implementation of the [FSAP] and other major EU legislative measures, will continue in 2007. Although these initiatives are designed to reduce risk and improve efficiency in the long run, the sheer volume of change heightens compliance risk for firms and puts pressure on scarce resources, potentially with high opportunity cost and increased operational risk.”

In the UK, the need to address the issue of over-regulation was confirmed in November 2006 when the latest biennial survey by the Financial Services Practitioner Panel found the majority of firms thought the regulatory regime placed too great a burden on them [see appendix 1]. That burden was felt particularly keenly on the retail side of the industry and by smaller firms, who had seen no improvement over the past two years despite the good intentions of the FSA. Retail firms also reported, proportionally, the highest compliance costs in a survey conducted by Deloitte for the FSA and the Practitioner Panel [see appendix 1].

Large firms, with a heavier bias towards wholesale business, are happier with the regulatory system, as experienced in the UK. Their relative approval echoes the praise directed at the FSA by some American politicians and business leaders, who compare the UK regime favourably with their own because it is more principles-based and because the FSAs consolidated power contrasts with their fragmentated system. But in the UK, complaints persist about a drift towards the more prescriptive and legalistic US system.
**Industry responsibility**
The UK financial services industry bears its share of the blame for the build-up of regulation. Scandals associated with the abuse of investors and customers, from pensions mis-selling to split capital investment trusts, have lent support to those who want to regulate the industry more tightly. Such abuses have created the impression that a clever industry takes advantage of financially illiterate customers by selling them unsuitable products. Fred Reichheld, a director emeritus at Bain & Company and author of a book on “good profits”, classes profits made by “customer abuse” as bad profits: instead of driving growth, they drive customers away. So, it is in the interests of the financial services industry, like any other, to give customers a good deal and keep the regulator off its back.

Short of abuse, overly complex product ranges have made it difficult not only for customers to find the most suitable product, but for staff to understand what they are selling. The uncertain outcome of many investment products may also increase the scope for misunderstandings between sellers and unsophisticated buyers.

While the need for regulation to address the main problems is undeniable, the industry needs to go as far as possible towards removing this imbalance itself. The FSA’s discussion paper on Industry Guidance, published in November 2006, recognises this and its April 2007 document, Principles Based Regulation - focusing on the outcomes that matter, says: “We see a greater role for sector-specific guidance and support provided by industry associations, professional bodies or groups of firms” [see appendix 3].

The FSA has a statutory and practical commitment to consult, and does a better job than many of its peers. On the wholesale side, there are some notable examples of it soliciting a market solution instead of writing new rules itself. But on the retail side, considerable scope remains to involve market participants, including consumers, at an earlier and more meaningful stage.

**International and national sources**
Since the turn of the century, there has been an escalation in the amount of cross-border regulation and an expansion of national regulatory bodies detached from the industries they cover. This has tended to replace old systems of self-regulation. The FSA is a prime example [see boxes 1A-C]. Since 2001, it has taken over the supervisory role from seven industry-based bodies, in addition to the banking oversight it had already acquired from the Bank of England and the listing rules from the London Stock Exchange. Its powers to pursue and punish transgressions, such as market abuse, have been increased. By 2006, staff numbers exceeded 2,800 – although the authority now plans a 10 per cent cut.

---

**Ratcheting-Up**
Causes of the ratcheting-up of regulation include:
- responses to corporate scandals that apply to all sectors – the Sarbanes-Oxley Act, for instance;
- US-led responses to abuses in the financial services sector, such as reforms of the research function at investment banks;
- responses in the UK to the mis-selling of financial services and solvency issues;
- the EU’s desire to create a single market under the FSAP;
- global initiatives in the financial services industry, notably the Basel II revision of the 1988 Basel Capital Accord;
- ubiquitous measures to combat financial crime and the funding of terrorism.
Such intensification of national regulation has run in parallel with moves to create international standards, reflecting the cross-border activities of many businesses. These initiatives have the potential to rationalise regulation: the replacement of local accounting practices with international accounting standards, for instance. But these international regimes are often more burdensome than the national ones they replace. And national differences in adoption and implementation can lead to firms enduring the costs of new regulation without enjoying the benefits of harmonised cross-border rules. The slower and more limited adoption of Basel II in the US is an example of this. National regulators may also lever up the costs through different interpretations.

Insufficient co-ordination between regulators on issues of compatibility and timing has compounded the problem, raising the question of how global refereeing of regulatory activity might be better performed.

**Principles, prescription and minimum standards**

In many fields of regulation, there has been an apparently irreversible trend towards more prescription: the FSA Handbook weighs in at more than 8,500 pages, for instance. Reasons for this include the regulator’s tendency, often in response to political pressure, to add to the list of specific proscribed actions after each new case of abuse; increasing intrusion into areas previously seen as the responsibility of management, such as the competence of employees; and the search for clarification on the part of the regulated. Some characterise the American regulatory culture as “rules-driven”, and hence detailed and prescriptive. This is contrasted with the more principles-based approach of the UK, where the advantages are somewhat idealised. In practice, few lean against the wind of seeking certainty through prescription.

The good news is that the US is following the UK regulator in seeking to reverse the prescriptive tide, for fear of its capital markets becoming less competitive. In November 2006, Hank Paulson, the US Treasury Secretary and former chairman and CEO of Goldman Sachs, said: “Excessive regulation slows innovation, imposes needless costs on investors, and stifles competition and job creation.” And the Committee on Capital Markets Regulation, an independent American group chaired by Glenn Hubbard and John Thornton, has “reducing regulation” as one of its main aims [see appendix 4]. Moves have been made, for instance, to lighten the burden of section 404 of the Sarbanes-Oxley Act, which deals with internal controls.

The FSA has renewed its efforts to be a principles-based regulator, which involves refocusing on its 11 high-level standards, or principles. John Tiner, chief executive, has described principles as “more future-proof, i.e. better at accommodating and encouraging innovation in the market place”. This is in line with the FSAs risk-based approach, “which requires supervisors to focus on the outcome”. Since no-one is proposing a “principles only” approach to regulation, there will always be a series of rules that clarify how to abide by the principles. The questions are: how to keep detailed prescription to a minimum, how to avoid disproportionate cost and how to ensure that the measures help the market operate better.

---

**The UK’s more principles-based approach is somewhat idealised**

No one is proposing a ‘principles only’ approach to regulation
If principles-based regulation is to work well in practice, it should assume – as the FSA says it does – that responsibility for detailed, practical implementation lies with managers of the business. So that each firm does not have to reinvent the wheel, a logical response is for businesses to get involved in developing minimum standards to the extent necessary to implement new legislation, whether it be national or cross-border. It also makes sense for consumer representatives to be involved, since the aim is not just compliance but to “treat customers fairly”. TCF, as required by Principle 6, is of course the subject of a current FSA initiative [see appendix 3].

However, for those minimum standards to replace much of the regulator’s prescriptive activity on the retail “conduct of business” side, a more radical approach is needed than simply adding voluntary industry codes to the FSA’s comprehensive efforts. This report sets out proposals for devolution of standards-setting to sector-based bodies comprising industry practitioners, consumer representatives, academics and other experts.

A retail focus
The working group focused on the retail element of financial regulation in the UK because that is where the greatest complaints about over-prescription and cost lie. Those representing the wholesale side on the working group expressed concern about regulatory drift from the retail side, as a wider range of products is sold to retail clients. However, the FSA’s structure, which splits wholesale markets, retail markets and regulatory services into separate divisions, does facilitate different approaches. The wholesale business unit has developed relationships with practitioner/expert bodies that allow them to suggest solutions, such as guidance on managing analysts’ conflicts of interest. Nevertheless, wherever market-savvy regulation exists, it cannot be taken for granted and political concerns can at any time prompt a flurry of activity – related to the financing of terrorism, for instance.

The burden is undeniable. The question is whether the investment in so much regulation is worth it. Bearing in mind that a zero-failure regime is impossible, do the benefits outweigh not only the direct costs but also the less tangible disadvantages of creating barriers to competition, making saving more complex and undermining individual responsibility?

The timing is propitious. Regulators and politicians are taking stock. Charlie McCreevy’s agenda, since he became European Commissioner for the internal market in 2004, has been to focus on implementing laws already passed rather than on inventing new ones. And this year (2007) the Commission will launch a review of the FSAP. The FSA already has a “better regulation action plan” and has promised to cut both the rulebook and its own staff. With the search now on for a new chief executive, following John Tiner’s decision to leave in July, an opportunity exists to
take the authority to a new stage in its development. This will be informed by the findings of the National Audit Office, which reported in April. The NAO emphasised that “staff are the crucial ingredient” in both principles-based regulation and the attempt to move beyond process to focus on outcomes.

This CSFI study also coincides with a number of reports examining the regulatory process by, among others, the London Investment Banking Association and the International Council of Securities Associations, and the Institute of International Finance [see appendix 4]. Our report differs from these in that it involves a broad range of interests: consumer representatives, academics and politicians, as well as industry practitioners.

The aim is to produce constructive proposals for improving the approach to regulation in general and the UK regulatory system for retail financial services, in particular. We hope it will be embraced by the industry and its customers, politicians and regulators as a cogent and practical agenda for change.

**Box 1A: Diminished independence of the UK authorities**

Any discussion about making regulation in the UK more effective has to take account of the limitations on the FSAs and the Government’s scope for independence in policy formation and supervisory action. These functions are increasingly concentrated in the EU Commission and the Committee of European Securities Regulators (CESR), where the voice of the UK authorities is one among many.

The Commission has a monopoly on the introduction of pan-European legislation, although passage is subject to approval by member states and the EU Parliament. Directives are transposed into national law by member states, which in the past has given them considerable flexibility at the national level (subject only to time-consuming and uncertain enforcement action, which the Commission has traditionally been reluctant to undertake).

The Commission’s increasing use of Regulations, which become, in effect, national law, has narrowed that flexibility considerably. For example, in MiFID, the controversial elements of equity market transparency and transaction reporting are to be implemented by pan-European Regulation, as have been share buy-back and stabilisation provisions in the Market Abuse Directive.

> In financial services, under the Lamfalussy process, the policy-forming stage is known as level 1 and the drafting of the Directive, level 2. Level 3 aims for consistent implementation and level 4 deals with enforcement.

Even when legislation is implemented by Directive, the Commission has begun to impose constraints such as MiFID level 2 Article 4 intended to prevent member states adding to, or “goldplating”, the legislation. Generally the industry has welcomed this second development but it is part of a total package aimed at increasing the degree of harmonisation of regulation across Europe, encouraging supervisory convergence and thereby achieving the goal of creating a single EU market in financial services.
The role of the FSA's policy teams has been markedly reduced in recent years. Their main task now is to argue for a particular policy line within CESR and the other level 3 committees. In this context, CESR's job is to advise the Commission, when requested, on the practical issues that will arise if the legislation is framed in a particular way. It subsequently issues guidance on implementation which member regulators are under considerable pressure to adopt. This frequently sets out in considerable detail the content of rules and guidance to be issued by national regulators.

If the FSA were to be regularly out-voted, or if it frequently rejected the consensus view as reflected in CESR guidance, that would damage its ability to exercise the leadership role it should have given the importance of the London markets to Europe as a whole. Similarly, if CESR advises the Commission, and then attempts to get member regulators to act in a co-ordinated fashion at Level 3 in ways that do not adequately reflect the needs of the London markets, particularly its professional markets, then the interests of the UK are damaged.

The FSA needs to persuade its peers and build alliances. It is a difficult balancing act to do so without conceding too much. Similar issues arise with the other Level 3 bodies, CEBS and CEIOPS. The Government – notably the Treasury – is in a similar position, but as regards agreeing Directives and Regulations in Brussels this has always been the case. Decision-making by member states, based on qualified majority voting, requires building and maintaining alliances. This has undoubtedly become more difficult and complex in an enlarged EU.

Much depends on the quality and experience of staff in post at the time and the extent to which ministers are prepared to devote time and resources to arguing the UK case in the final stages of a negotiation. Generally, the winner of the end game is the member state that demonstrates to the Commission the greatest resolve to fight for its preferred text.

Richard Britton

Box 1B: The FSA's power

In spite of the limitations on national autonomy, the FSA is sometimes described as the most powerful financial regulator in the world. Not only does it oversee almost every industry sector, but it combines conduct of business regulation, encompassing consumer protection, with prudential regulation, or responsibility for ensuring that firms remain financially sound. It inherited the latter duty from the Bank of England and the Securities and Investment Board in 1998.

The FSA also straddles retail markets and wholesale markets. But not everyone agrees that these different types of regulation should be mixed and some countries – Australia and The Netherlands, for instance – keep certain regulatory activities separate. [See appendix 2: essay by Charles Goodhart.]

In financial services, in particular, the gap between informed practitioners and a naïve public is perceived to be a wide one. This creates different regulatory pulls. On the one hand, a “light touch” is demanded for the wholesale side. Not only can the professional participants look after themselves, but also this international business, with its electronic trading base, can flee from a heavily regulated regime to a lighter one. On the other, the consumer protection imperative is used to justify increased regulation and tight supervision. Should both types of market be covered by the same regulator?
The argument for keeping them together is that financial institutions are often involved in both activities, and that the underlying principles of fair and open markets are the same. Drawing the line is more difficult than it appears: which side of it do pension funds fall on, for example? Conduct of business (COB) and prudential governance are also linked because institutions that design and sell financial products, especially long-term ones, need sufficient reserves to back them – something that Equitable Life turned out not to have. The majority of the working group preferred the unitary approach of the FSA, particularly to prudential regulation. Most regarded the separation of wholesale and retail markets into different business units as a valid attempt to accommodate different approaches and cultures. International firms in particular, which tend to be involved in both retail and wholesale activities, favour the one-stop shop offered by the FSA.

Those who argue for separation say that the FSA has the same drawbacks as any other conglomerate. Its diverse, even contradictory, regulatory goals make it difficult to achieve any of them with maximum efficiency and militate against a coherent culture. The regulatory imperative in the retail sector is to protect (ignorant and therefore vulnerable) customers. This leads to calls for prescriptive COB rules and detailed compliance scrutiny. By contrast, the regulatory imperative in wholesale markets is to guard against systemic risk and to trust market forces. The danger lies in these very different philosophies contaminating each other, causing too much interference in transactions between professionals and too much laissez-faire when gullible members of the public are involved. [See appendix 2: essay by Stani Yassukovich.]

The FSA does, however, share power with the Bank of England in terms of systemic risk, the Office of Fair Trading (OFT) on competition and pricing, and the Financial Ombudsman Service (FOS), which deals with individual consumer complaints.

A final area of concern is the combination of regulatory functions within the FSA. It sets, implements and enforces regulation, pursuing firms and practitioners for breaches of both principles and detailed rules. Taking its agglomeration of sectors and functions together, the FSA can be seen as an ambitious experiment in how far the trend towards bundling regulation under one roof can be pushed.

**Box 1C: Regulatory overlap**

In March 2006, the FSA and OFT produced a joint action plan, Delivering Better Regulatory Outcomes, which includes collaborating in areas of overlap, reducing administrative burdens on jointly regulated firms and working with the FOS. Yet concern remains that competition between regulators to prove their credentials as the consumer’s champion may prompt unnecessary action. The working group suggests:

- The Ombudsman’s role should be limited to adjudicating in individual cases, counteracting the concern that it is over-active and strays into setting policy. Where the weight of complaints suggests a systemic problem at a company or across a sector, this should be passed on to the FSA.
- Where the Ombudsman finds a pattern suggesting unfair pricing, that should go to the OFT.
- Consumer credit is perhaps the biggest area excluded from the FSA’s empire. The logic of the “one-stop-shop” approach might suggest that it should acquire it. But with the authority already regarded as being difficult to manage because of the breadth of its responsibilities, this does not seem practical at this stage. Much is riding, therefore, on the effectiveness of the FSA/OFT Action Plan.
CHAPTER 1: THE OBJECTIVES OF REGULATION

The working group starts from the premise that regulation should be kept to a minimum. In retail financial services, however, there is pressure to set the bar marked “minimum” higher than in other industries because of low levels of financial literacy and the high level of risk that individuals may be exposed to [see box 1: Why are financial services so heavily regulated?]. But the sometimes paternalistic concern for consumers and the tendency to impose additional rules following every instance of harm make it all the more important to have a clear idea of when new regulation is justified and what the limits should be. The working group suggests the following objectives:

To prevent systemic failure
The starting point is the need to avoid systemic failure: to protect the financial system from the collapse of any component that could bring the entire system down. This does not mean protecting every firm from collapse. As one member put it: “Financial regulators are working on an invalid premise, i.e. that their job is to make all financial intermediaries behave up to the standards developed by the best; rather than that their role is just to prevent market failure.” Indeed, the occasional failure of a badly run firm is a sign of health in the capitalist system.

To encourage efficient markets
The best approach is to ensure that markets are fair, efficient, transparent and competitive. Giving customers the information they need to make a rational decision is an important part of this. Another key factor is competition between providers for their custom. It is important that different institutions offering different products operate on a broadly level playing field and that new entrants are not precluded from entering the market. [See box 2: Competition and financial regulation.]

To provide consumer protection
Consumer protection is one of the duties of the FSA and many other statutory regulators. The political motive is clear: consumers are voters. Less cynically, the tax-funded social security system often has to pick up the pieces when savers lose their investments through fraud or negligence. In retail financial services, there is perceived to be a particular need to prevent one side of the transaction abusing the other. The danger is, however, that the principle of “caveat emptor” is rendered meaningless. Buyers should not be protected from their own mistakes, except where their knowledge is grossly inadequate and the vendor has taken advantage of this. In his Review of Investor Protection in 1984, Professor Gower said that regulation should not “seek to achieve the impossible task of protecting fools from their own folly” but instead should “be no greater than is necessary to protect reasonable people from being made fools of”.

Public policy objectives
This is more a pragmatic point than a top priority. It is a fact of life that national interest creeps into the political stages of setting legislation even if technocrats try to keep it at bay. So neither UK politicians nor regulators should ignore London’s...
Box 1: Why are financial services so heavily regulated?

Why are financial markets and services regulated? And why are they regulated more heavily than many other parts of the business world?

Buying a car is, in some ways, as complicated and potentially dangerous a decision as investing in a life insurance policy. The discovery that it is flawed may also occur at a life-threatening moment. Yet car sales are subject to much lighter regulation than financial services. People also feel more comfortable buying a car than buying a life insurance policy, even if they do not know what goes on under the bonnet. Why is this? Is it because they think they understand cars and trust the salesman?

Sellers of financial services are required to “treat their customers fairly”, a stricture that is not imposed on sellers of most other goods and services. Railway travellers might benefit greatly from a requirement on train operators that they treat their customers fairly.

Is society being unreasonable in setting much higher standards for financial services than other types of business? The answers most frequently given for imposing tough regulations on financial services are:

- their importance. Dishonest or inefficient markets are bad for the economy as a whole.
- the risk of systemic failure. The financial services industry is highly geared and the failure of one large bank could have catastrophic knock-on effects.
- to protect consumers. Purchasers of financial services are often in a weaker position than sellers because they know much less about what they are buying.
- to reduce financial crime. The financial services industry is vulnerable to many types of crime: fraud, manipulation, dishonesty, and needs to be closely policed.

The CSFI working group does not dispute these reasons, but nor does it believe that they provide an unquestioned justification for ever-increasing amounts of regulation. The objective should be to bring financial services regulation to a level where it does not seem different from the regulation of other important parts of the economy where business activity and the purchasing decisions of consumers are subject to risk.

David Lascelles

importance to the economy as a capital markets centre. The FSA does have this as a consideration. But the message is at least as important for politicians, who are less likely to have a good understanding of financial markets yet must defend well functioning elements of the London market in Brussels and elsewhere.

Recommendations

Statutory regulation should apply only where it is strictly necessary and no other body or set of people can achieve the same ends. A regulator should always:

- describe the systemic or market failure that any new measure is addressing;
- state why existing rules are inadequate: the issue may well be one of enforcement or a need for heavier penalties, rather than a regulatory vacuum;
- state why other solutions – market-based or emanating from the industry – would not work.
The FSA certainly talks the talk on this. In his introduction to the 2007-08 Business Plan, Sir Callum McCarthy, chairman, referred to the authority’s “determination to seek market solutions where possible, and intervene by regulation only where the market does not provide a solution and when the benefits of intervention outweigh the costs; and an explicit recognition that it is neither possible nor desirable to seek to prevent all failures”. But there are two problems. First, much regulation emanates from the EU or other cross-border initiatives, where legislators are more wedded to statutory solutions and are less market orientated. In response to this, the importance of the FSA and the UK government, particularly the Treasury, exerting influence at the international level cannot be stressed enough. And they will be better informed if market participants are prompt in joining the debate. Second, persistent practitioner complaints, rising regulatory costs and little evidence that customers are getting a better deal suggest that the authority does not walk the talk often enough. The many reasons for this include the natural regulatory inclination to intervene, the large quantity but questionable quality of some of its staff, and too paternalistic an approach to retail regulation.

The benefits of regulation should outweigh its disadvantages

Even if there is a theoretical case for regulation, it may not be possible to take action without adverse consequences, which are bound to include cost. These must be rigorously assessed. As the FSA often says, regulation must be risk-based and proportionate. This means it is not worth doing anything if the harm being addressed is minimal or the potential gain insignificant. Support for cost-benefit analysis (CBA) now seems to be universal, even though the measurement of benefits is particularly difficult. How do you put a value on increased consumer confidence, for example? Even on the more straightforward cost side, much work needs to be done on measurement methods. The Open Europe study of the Financial Services Action Plan quotes cost estimates from about 15 sources for 20 Directives. But what is striking, apart from the eye-watering total bill of €60bn-€100bn by 2010, are the disparities: £1.2bn-£6.5bn for MiFID in the UK, for instance. [See appendix 1.]

The FSA is regarded as being one of the leaders in the CBA field, and yet its attempts to review the cost of existing regulation are in their infancy. The Deloitte exercise only covered three sectors – and only one of those was on the more burdensome retail side. And the disparities in its findings serve to emphasise the sheer difficulty of the measurement task. The FSA continues to move in the right direction: in September 2006 it commissioned OXERA to develop a framework for assessing the benefits of financial regulation.

The European Commission has a “Better Regulation” plan [see appendix 4] that includes simplifying legislation and creating an Impact Assessment Board. Welcome, but the sound of stable doors being shut after the horse has bolted is loud. And we have had to wait until now for the European Council to fix a joint target to reduce administrative burdens by 25% by 2012. At least the need to undertake such assessments imposes a discipline on policy makers, as well as providing an entry point for the industry and others to propose alternative courses, including “no action”.

New regulation should always improve on, or replace, old. As none of the crimes is new, previous attempts to combat them are bound to have been made. So, an
automatic clear-out of old legislation should accompany the promulgation of anything new. This is a common element of all “better regulation” plans, but the results are barely visible yet. The Commission has “over 100 initiatives to review laws on the book”. The FSA at last came out with new “conduct of business” proposals in late 2006, as part of the MiFID implementation programme, which should halve affected sections of the Handbook.

The Dutch have a body called Actal, set up by the government to pursue a target of cutting administrative burdens by 25%. However, this “barnacle-scraping” exercise would probably be done best by the regulator, or sector standards setter. Lessons would be learnt from tackling the problems it had created, the follow-through would make it more accountable and the time spent revising existing rules would limit the capacity for new initiatives, forcing the regulator to focus on urgent priorities.

Some group members, representing multinational firms, believe that international convergence of regulation – the spread of international financial reporting standards, for instance – is one way to improve on old, nationally based regulation. The advantages include ease and reduced cost of operating across borders, elimination of regulatory arbitrage and more efficient markets. The cost of capital is reduced when business has access to it through different markets using the same procedures. But if such standards are not universally adopted, some firms in some countries end up simply incurring considerable expense in implementing new legislation. Where the benefits of new regulation are difficult to quantify, as in the case of Basel II, the cost disadvantage becomes a competitive disadvantage.

**Recommendations**

- Regulation should always undergo an independent cost-benefit analysis, or impact assessment. This is already required of the FSA, but methodology needs to be improved. The EU is improving its approach to “impact assessment”, but the pace is slow and it must embrace the need for independent CBA. A specific aim of every consultation exercise must be to try to predict unintended consequences.
- There should be more systematic retrospective evaluation of regulatory costs to identify areas needing reform and assess the accuracy of previous CBA.
- Where it is impossible to quantify costs and benefits in a meaningful way, it is essential that the regulator provides a narrative explaining why it nevertheless thinks that more regulation is essential.
- The Better Regulation Taskforce recommended adoption of the Dutch one in-one out approach. This is a start, but focusing on the most burdensome rules and on an overall reduction is better.
- Where international rules are applied, national ones must be repealed.

**Regulation should be based on principles**

A guiding principle, embodying the spirit of the law, is needed against which behaviour can be measured when there is no specific rule banning it. Every regulator should have a small number of durable principles, which cover each broad category of potential abuse. New initiatives in principles-based regulation, such as “Treating
Customers Fairly” suggest that principles can mushroom just as easily as rules do. However, TCF is not new: Principle 6 of the FSA’s 11 High Level Standards [see box 3] states that “a firm must pay due regard to the interests of its customers and treat them fairly”. It would have been better to present TCF as part of a refocusing on the principles, backed up by enforcement on the basis of principles alone – as is rightly happening – rather than as something new.

But principles can be too vague and platitudinous: the exhortation to “treat customers fairly” might be accused of this. The remedy - an occasional review of wording - need not necessarily make the statements long and cumbersome. It is worth repeating...
Professor Gower’s words in this context: that regulation should “be no greater than is necessary to protect reasonable people from being made fools of”.

The working group supports the idea that the board and management of each firm are responsible for ensuring that the principles are adhered to. In corporate governance terms, a firm is required to manage risk, not just to comply with the rules, and the board is held responsible for its actions. This ought to result in less intrusive supervision by the authority, although penalties will need to be severe enough to ensure senior management is motivated to apply effective internal controls. The

---

**Box 3: The FSA Principles**

1. **INTEGRITY**
   A firm must conduct its business with integrity.

2. **SKILL, CARE & DILIGENCE**
   A firm must conduct its business with due skill, care and diligence.

3. **MANAGEMENT & CONTROL**
   A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

4. **FINANCIAL PRUDENCE**
   A firm must maintain adequate financial resources.

5. **MARKET CONDUCT**
   A firm must observe proper standards of market conduct.

6. **CUSTOMERS’ INTEREST**
   A firm must pay due regard to the interests of its customers and treat them fairly.

7. **COMMUNICATIONS WITH CUSTOMERS**
   A firm must pay due regard to the information needs of its clients and communicate information to them in a way which is clear, fair and not misleading.

8. **CONFLICTS OF INTEREST**
   A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

9. **CUSTOMERS: RELATIONSHIP OF TRUST**
   A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.

10. **CUSTOMERS’ ASSETS**
    A firm must arrange adequate protection for clients’ assets when it is responsible for them.

11. **RELATIONS WITH REGULATORS**
    A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.
Recommendations

- Regulators should have a clear and concise set of principles. The FSA has 11 of them. The content would benefit from being reviewed to ensure that each one provides an effective litmus test for judgments of substance over form.
- It should be clear under which principle each new rule falls.
- Boards are responsible for ensuring that their companies follow the principles i.e. that they comply with the spirit of the law as well as the letter. Where the board has a strong independent element, the relationship with the regulator should reflect this.

What regulators may be under-estimating, at least at larger firms, is the impact of corporate governance reforms over the past few years. Boards have been made more independent of management and the duties of non-executive directors have been more clearly defined. Directors are required to ensure that internal control and compliance breaches are independently reviewed and remedied. The regulator should, therefore, be able to work with a company’s board when it believes principles have been breached.

The main difficulty with principles-based regulation is uncertainty about what the regulator expects firms to do. If the industry is nervous about changing interpretations of principles, or about outbreaks of zealotry related to political pressure, this can result in over-compliance. One member of the working group asked: “How much of the increasing cost of regulation is self-imposed?” Another suggested that the industry sometimes seeks “a comfort blanket in the rules”. If this uncertainty is not going to be settled by rules, then more co-operation will be needed between the regulator and the regulated to fill that gap.

So, ironically, even if companies are freed from detailed, prescriptive rules, uncertainty will have a similar clogging effect if management fills the vacuum with detailed and prescriptive codes of conduct. As one member said: “Principles-based regulation can work but it requires changes in behaviour of all those concerned.” On the company’s side, this places the onus on the board to focus on principles and to ensure that the resulting message of substance over form filters down through the organisation.

On the regulator’s side, it calls for high-calibre staff capable of exercising judgment, who have the authority and confidence to give firms informal guidance. But the latest survey by the Financial Services Practitioner Panel says: “Many retail firms found that high staff turnover (internal and outward) at the FSA meant that little understanding and corporate memory has been developed.” The FSA plans to spend £50m over the next three years (from 2007-08) “to improve the effectiveness of our people”. At the same time it aims to cut a net 10% of its 2,800 staff. The investment should cover a bold move towards employing fewer but better people, and rewarding them appropriately. Making more use of outsiders might also be more cost-effective. Knowledge is, in any case, not enough if the incentives to find industry-based, or common-sense, solutions are lacking. Are staff ever rewarded for advocating no action, for instance?
Box 4: What the objectives of regulation should NOT be

The working group believes the causes of bad regulation include:

• Trying to force all financial intermediaries to match the standards of the best. There is a temptation for regulators to prescribe in detail how firms should behave. The aim should be to do the minimum required to prevent systemic risk or customer abuse. Competition should take care of the rest.

• Knee-jerk reactions to events attracting media attention and political pressure to be seen to be doing something about a problem that may be exaggerated. Examples include the effect of money-laundering regulation on members of the public seeking to open a bank account.

• Attempts to create a zero-failure regime. This is impossible. Trying to head off failure through regulation may cost more than the consequences of such a failure.

• Ignorance of alternative ways of addressing the problem. Legislation should be a last resort.

• Attempts to control prices in competitive markets. The failure is usually one of competition, or of a lack of information for the purchaser.

• Gold-plating of cross-border regulation by local bodies. A self-denying ordinance is needed by national regulators: they should seek to repeal the rules that are superseded by international ones.

• Losing sight of the over-riding objectives of having efficient and competitive markets, a healthy financial services industry and a capital that deserves its reputation as a good place to do business.

Regulation is NOT intended to:

• save foolish (or greedy) individuals from the consequences of their folly (or greed);

• save shareholders from the consequences of managerial incompetence – or managers from the consequences of bad decisions;

• advantage one type of financial services provider over another – or protect a financial centre from desirable change;

• replace other forms of sanction where the general opinion is that such sanctions work satisfactorily – eg, for the most part, in wholesale markets.
CHAPTER 2: THE FORMULATION OF REGULATION

From principles to minimum standards
The working group is in favour of principles-based standards. These could be seen as forming the top of a roller blind, from which regulation unfurls: first, and minimally, for wholesale markets; and then in more detail for retail markets. Moves the other way, extending retail regulation to the wholesale side, should be very limited. The problem obviously arises when products, such as hedge funds, start to be marketed to retail as well as wholesale customers. But this can be dealt with by point-of-sale regulation, notably governing customer suitability, rather than by moving regulation upstream. Having wholesale and retail regulation under the same roof does risk contamination: too much regulatory intrusion into wholesale markets and too much laissez-faire in retail.

On the wholesale side, where business is conducted between professionals, the consistent call is for as much as possible to be left to market forces. The FSA is right to have divided wholesale and retail supervision into separate business units. This should encourage the wholesale unit to have a different regulatory culture, which places more trust in market forces and is less worried about market participants’ losses. Its more flexible, market-orientated approach involves operating through market-based bodies, such as the Takeover Panel [see box 1], and having regular access to individuals who remain in private practice. For specific purposes, semi-autonomous taskforces can be called on, as with the reform of over-prescriptive money laundering regulation by the Joint Money Laundering Steering Group [see box at end of chapter]. Increasingly, the first port of call in tackling a problem has been to ask those involved in the relevant market to offer a solution, as with the unbundling of equity research costs from trading commission.

Reform of the retail regulatory structure
The greater challenge lies on the retail side where there is a need for closer control of the way financial institutions conduct their business. Nevertheless, the effective approaches described above for the wholesale markets could be extended to the retail side. The working group believes that embedding producers, intermediaries and users in the regulatory process will improve it. When the regulator reckons that a change is necessary, it is worth enlisting at the outset those who devise, sell and buy the product. Consultation, reinforced by the practitioner and consumer panels, is not enough. This top-down process can waste effort as firms respond to a stream of discussion and consultation papers. It would improve the process if practitioners were able to nip unnecessary initiatives or over-prescription in the bud. And it is better to have their clients involved, too, who also want the market to operate efficiently and cheaply. From a retail customer’s point of view, clear, concise information and unbiased advice are the key to understanding products and services, whereas complex forms and procedures create barriers and add to the cost of products.
The constituency and a lack of resources compared with well organised trade associations. But this is to belittle existing consumer organisations, and to allow difficulty to get in the way of a good idea. The working group recognises that the representative role will need to be professionalised and adequately funded.

The FSA already has a quasi-sectoral sub-structure, with the laudable aims of making it easier to do business with, helping staff develop industry knowledge and fostering dialogue with firms. Our proposals for devolution of power would push this much further. This recognises that the trend away from self-regulation since the end of the last decade may have been at the expense of market intelligence, and of peer pressure to conform with standards designed to promote fair dealings and protect professional reputation. Indeed, many self-regulatory bodies continue this tradition, providing codes of conduct that fill regulatory gaps – in international capital markets, for instance.

In the UK, the working group believes there could be substantial delegation of responsibility for setting minimum standards to bodies that include the regulator’s representatives but are largely composed of practitioners, customers and industry experts. It is important that these bodies are not dominated by trade associations or other lobbying groups. The primary duty of members should be to produce the best regulation, not to champion special interests. Finding “consumer representatives” is deemed by some to be difficult because of the disparate nature of the constituency and a lack of resources compared with well organised trade associations. But this is to belittle existing consumer organisations, and to allow difficulty to get in the way of a good idea. The working group recognises that the representative role will need to be professionalised and adequately funded.

### Box 1: The Takeover Panel

The Takeover Panel was set up as a non-statutory body in 1968. In May 2006, it was designated by the Secretary of State for Trade and Industry as the supervisory authority to carry out regulatory functions under the Directive on Takeover Bids.

Acting independently, the Panel issues and administers the Takeover Code, and supervises takeovers and other matters to which the Code applies. The Code is designed to ensure that shareholders are treated fairly and not denied an opportunity to decide on the merits of a takeover. Shareholders of the same class must be afforded equivalent treatment. The Code also aims to promote the integrity of the financial market.

The essential characteristics of the Panel system are flexibility, certainty and speed, enabling parties to know where they stand in a timely fashion. This approach aims to avoid over-rigid rules and the risk of takeovers becoming delayed by litigation of a tactical nature, which may frustrate the will of shareholders.

The Panel focuses on the consequences of rule breaches, rather than simply on disciplinary action, with the aim of providing appropriate redress. If there has been a breach, the Panel may have recourse to private censure, public censure, suspension or withdrawal of any exemption or other special status it has granted. It may report the offender’s conduct to another regulator. Under the Directive, the Panel also has powers to require documents and information, to make compensation rulings and to seek enforcement through the courts.

Peter Scott QC is the current chairman and the Panel consists of up to 20 independent members, which it appoints. In addition, 11 members are nominated by financial and business institutions to ensure a spread of expertise. The Panel’s Code committee makes and reviews rules and procedure. Its hearings committee, which can be convened at short notice, reviews rulings of the executive and hears disciplinary disputes.
The FSA would still set regulatory goals and promulgate rules. The recommendations of sector bodies would go to it for approval.

**A proposal for structural reform**

The steps the FSA could take towards devolution might run like this. First it should review its nine “sectors”, which are:

- Accounting & Audit;
- Asset Management;
- Banking;
- Capital Markets;
- Consumers;
- Insurance;
- Retail Intermediaries;
- Financial Crime; and
- Financial Stability.

The last two can be omitted from the process: the reduction of financial crime is a statutory objective, and financial stability is a matter for liaison with the Bank of England. The retention of responsibility for financial stability implies that prudential regulation of firms, checking on the adequacy of their capital bases, should remain a central task. Other sector teams – capital markets and consumers – could either be absorbed into the FSA’s three main business units: retail markets, wholesale and institutional markets, and regulatory services; or incorporated into sector teams.

The devolution proposal concerns two types of “sector”. One is where there is overlap with another regulator. This occurs notably on Accounting & Audit, which is covered by the Financial Reporting Council. Does the FSA need a sector team devoted to this field? Why not shift the duties to the FRC, with liaison taking place between that body and the regulatory services unit?

The other area ripe for devolution is that represented by teams that cover industry sectors: asset management, banking, insurance and retail intermediaries. Here the scope for turning these into sector standards setters looks greatest.

The devolution map would, therefore, look like this:

Accounting & Audit - to Financial Reporting Council
Capital Markets - to main wholesale business unit
Consumers - either to retail business unit or sector standard setter
Financial Crime - remains as a statutory objective
Financial Stability - liaison with the Bank of England
Asset Management
Banking
Insurance
Retail Intermediaries \{ devolved to sector standards setters

It may be necessary to increase the number of sector bodies or to sub-divide broad areas such as banking and insurance. An important aspect of this is that the sectors define customer groups rather than where firms fall for supervisory purposes. The latter approach helps deliver the one-stop shop that large firms crave, but sectors are...
This FSA organogram shows what it describes as cross-FSA sector leaders. This is the layer of teams that the working group suggests should be reviewed.
better mirrors of markets, customer needs and professional development.
Fragmentation should be strictly limited to avoid a proliferation of bodies that
multi-service firms have to deal with, and the central role of the FSA would include
ensuring joined-up thinking and compatible action.

The second step would be to populate these sector standards setters with
representatives of the industry, consumers and the regulator, as well as academic
experts. Their relationship with the FSA would, at a minimum, involve keeping the
sector teams in-house but beefing them up by embedding practitioners, consumers
and experts in them. More radical would be to spin them out as semi-autonomous
units to carry out regulatory activities on behalf of the FSA: setting minimum
standards; revising and scrapping old rules; providing intelligence for supervisory
purposes. One way to do this may be to build up existing bodies such as the
Banking Code Standards Board. The degree of autonomy would be limited by the
FSA’s ultimate responsibility, as the designated independent regulator, for
implementing national and EU legislation.

Where legislation, wherever it emanates from, needs supplementing by minimum
standards for retail markets, these sector bodies would make recommendations to
the FSA for endorsement. They would also produce voluntary codes, or guides to
best practice, which the FSA might approve. Compliance with minimum standards
should help firms secure a safe harbour from prosecution for breaches of FSA
principles. Individual customers with complaints about a product or service would,
of course, always be able to take their cases to the Financial Ombudsman Service.

A key point is the importance of consumer representation on rule-making, or
standards-setting, bodies for retail financial services. The working group does not
believe that this would add to pressure for detailed and prescriptive rules. [See essay
by Mick McAteer in appendix 2] “The question,” as one member put it, “is whether
management is prepared to take responsibility for treating customers fairly”. This is
what the FSA wants, and the working group believes that management is prepared
to take such responsibility, working within a framework that involves the industry
more closely in regulation.

The advantage for the FSA is that devolution would carry principles-based
regulation to its logical conclusion. The authority would remain the guardian – and
policeman – of the principles. It would state the desired outcome of regulation
supporting those principles. But responsibility for devising more detailed conduct of
business rules, in the form of minimum standards, would reside with bodies that
have greater knowledge of the sector concerned and include consumer
representatives. It would help to bring home the point that company boards and
management must take responsibility for their businesses’ abiding by the principles.
And both firms and customers would benefit from rules that work better in practice
and cost less in terms of time and money.

Recommendations
• Those who regulate wholesale business should be encouraged to have a
different culture and approach from the retail side so as not to compromise
their belief in efficient markets and light-touch regulation. It should be stressed that this does not mean going soft on enforcement.

- Rules set for wholesale markets will have to be added to for retail markets.
- The mandatory part of regulation should be minimum standards. Guides to best practice may complement these but should remain voluntary.
- The FSA should review its sectors and consider: absorbing them into its main business units, switching their functions to other regulators, or beefing them up – and potentially spinning them off – as sector standards setters.
- Sector standards setters, composed of practitioners, consumer representatives and other experts, should draft and review regulation. This implies some switching of FSA technocrats to these bodies.
- The FSAs role remains that of director and overseer, setting regulatory goals in line with its principles, approving rules drafted by sector bodies and policing both principles and minimum standards.
- Compliance with minimum standards should give firms a safe harbour, or at least a “sturdy breakwater” as the FSA puts it, against future prosecution by the FSA, although individual cases will still go to the Financial Ombudsman.

**Reform of existing regulation**

Minimum standards, endorsed by the FSA, could be incorporated into a more streamlined Handbook. Rationalisation of existing regulation would be a prime task for the sector standards setters, making full use of the 2006 Legislative and Regulatory Reform Act (and assuming EU legislation affords the freedom to do so).

Another option is to build sunset clauses into each new rule to force a review. This is the case with the Markets Abuse Directive and in such instances the FSA should play a leading role in the review at EU level. But the setting of timeframes is arbitrary. Better, as with money-laundering, to focus on regulation causing significant complaint or which is found to be costly by follow-up studies. A prompt review could then be instigated at whatever level the offending rule emanated from.

**Recommendations**

- Regulation should be reviewed after implementation if there are serious complaints or evidence of onerous cost. Depending on the source, either the FSA should seek a solution, including wielding influence at international level, or the sector standards setters.
- On the wholesale side or for cross-sector problems, ad hoc teams such as the JMLSG offer another option in seeking effective ways to rationalise regulation.
- On a UK basis, the FSA and standards-setting bodies should ensure that the tools for regulatory reform enshrined in the Legislative and Regulatory Reform Act are used to the full.
- Ambitious targets should be set to shrink the size of rulebooks, as with the NewCOB revision.

**Minimum standards**

The working group discussed how sector bodies might go about setting minimum standards, with the aim of producing some practical recommendations, or templates.
Minimum standards should not be confused with voluntary codes of conduct, which may also be devised by standards-setting bodies where they believe guidance is sufficient. A precedent lies in the Accounting Standards Board, which sets compulsory standards, including implementing international financial reporting standards, but also produces “reporting statements”, which are guides to best practice. Where code-setters already exist, the Banking Code Standards Board [see box 2], for instance, the question is whether they would form the basis of the new standards-setting body for their sector, or continue to operate separately, producing complementary voluntary guides. If the latter, liaison between the two bodies would need to be very close, as it is between the BCSB and the FSA. Since new regulation should be a last resort (assuming the decision lies in the UK’s hands), a voluntary solution would be sought first. This is how corporate governance codes have developed in the UK.

But the working group’s preference for non-statutory responses should not be seen as a code-writer’s charter: voluntary measures create work and cost, too. Where codes may save duplicated effort for companies is in providing guidance on implementing legislation. MIFID Connect, for instance, is a joint trade association project designed

---

**Box 2: The Banking Code Standards Board**

The Banking Code Standards Board was formed in 1999 to ensure that banks, building societies and other providers of banking services complied with the Banking Code.

The Banking Code and the Business Banking Code (introduced in 2002) are sponsored by the British Bankers’ Association (BBA), the Building Societies Association (BSA) and the Association for Payment Clearing Services (APACS). The BCSB’s primary role is to act as an independent industry watchdog for the Codes. Nearly all banking service providers have signed up to the Banking Codes, which are binding on subscribers. Non-compliance can lead to a range of disciplinary actions including public censure and ultimately expulsion.

The BCSB’s main tasks are to:

- monitor and enforce the Codes;
- take disciplinary action where there are material breaches;
- advocate changes to the Codes;
- promote awareness of them;
- assist banking service providers in interpretation.

The Codes cover current accounts, savings and deposit accounts including cash ISAs, non-mortgage loans and overdrafts, card products and services and payment services, including foreign exchange. The FSA recognises the Codes, and to ensure that the “treating customers fairly” initiative extends to banking services, an equivalent principle has been proposed as part of this year’s revision of the Codes with a memorandum of understanding between the FSA and the BCSB on enforcement.

Gerard Lemos is the current Chairman of the BCSB and Robert Skinner the Chief Executive. The board has 10 directors, the majority of whom are independent, with a range of public service and consumer protection expertise. Each of the three sponsoring associations has one director.
to simplify the implementation of the Directive in the UK. The trend to principles-based regulation is likely to encourage such self-help initiatives.

Minimum standards for retail products and services
Simple descriptions
A prime concern of the working group was the complexity and opacity of some products and services. This not only makes it hard for customers to understand them but for firms to train staff to sell them appropriately. This problem, common to several retail sectors, is recognised by the FSA, which is calling for clear, simple and understandable information as part of its TCF initiative.

A minimum standard tackling this would say that every product family must have a brief and simple description of what it does, whom it is aimed at, the risks and the costs. Having a short and clear product description should make it easier to develop promotional material that is not misleading. The benefits for customers are obvious in terms of helping them to make informed choices. For firms, the motive would be to limit the reputational risk that stems from mis-selling, or mis-buying (obviously less serious but still a source of ill will). A template on mortgages has been produced by the group [see appendix 5].

Risk ratings or labels
One of the most difficult questions is how to inform customers about risk. While recognising that customers’ risk appetites vary and that risk can be mitigated through the overall construction of a portfolio, the working group believes that the risk inherent in the product should be spelt out. A clear explanation of risk should be part of the product description, as already indicated. To complement this, a system of risk rating, as found in a wide range of managed funds, could be extended to other retail savings and investment products. Risk is one component of the fund rating systems offered by Lipper, Morningstar and FT Fund Ratings, among others, which also address such factors as charges and past performance.

Where the sector standards setters decided that a particular product family was suitable for a risk rating system, compliance with it would be voluntary. Because the buyer’s circumstances are also crucial to an overall assessment of the risk, he or she will often still need advice before making the purchase. This would be recommended for risk ratings above a certain level. The sector standards setters could invite ratings agencies, financial advisers or publishers of financial information to submit risk-rating models. [See appendix 1: essays by Peter Wilson-Smith and Charles Goodhart.]

Traffic light systems have been considered in the past in some branches of financial services but abandoned as too difficult – or too simplistic. Nevertheless, as the debate over food labelling shows, there is tremendous consumer desire for clear, up-front information. The working group believes this is as relevant to financial services as to the supermarket shelves.

The FSA has identified three broad categories of financial product closely related to their riskiness. These could be incorporated into explanations, or used as a starting point for a labelling system. First come “search” products – ones that the customer
must have or seeks out, such as car insurance and tax-free ISA savings accounts, where the capital is secure and access is instant. They tend to be commoditised, of similar quality and the price is clear. Light regulation is appropriate for such products, which can typically be sold with no advice. The Government’s tendency to load the FSA with additional areas of supervision, such as travel insurance, should be resisted, particularly for such simple products. It is enough for the FSA to assess the solvency and uprightness of the provider.

The next level up is known as “experience goods”. Here, the customer has some knowledge of the product or service, but is not sure of its benefits until he or she has received it – the quality of service from a financial adviser, for instance. But the outcome is clear within a relatively short period of time, i.e. experience soon shows.

Most risky are “credence goods”, where the customer has no certainty of outcome but the product may work in the long term, such as an endowment mortgage. It is bought because the customer believes (but does not know) it is a good product but could find out years later that it will not fulfil expectations. “Hope goods” might be a more accessible description than credence.

While financial services are often more complex than, say, electrical appliances that carry labels indicating energy efficiency, the working group believes that the concept of risk labelling is worth considering for a wider range of savings and investment products (it is not necessary for insurance). One of the merits of the exercise is that it makes managers look at the product from the customer’s point of view.

Minimum standards for sales
The distribution process
In September 2006, Sir Callum McCarthy threw down the gauntlet to the savings and pensions industry in a speech that was highly critical of the distribution system for retail customers. He said it “serves neither the producer of the services nor the consumer of the services. It is doubtful whether it serves the intermediary either.” His main criticisms were:

• The system is focused on business volume rather than quality.
• Persistency of policies is low – in other words, the drop-out rate is high.
• There is much activity in the pensions market, but it is not clear how much of it is in the customer’s best interests.
• The picture is incompatible with developing a good reputation for either the industry or individual companies.

In short, the system suffers from “product bias, provider bias and churn”. At the heart of the problem is the commission system, which may lead to inadequate advice to customers on action, or inaction, that will not remunerate the intermediary. There is a dearth of advice on paying off debt, for instance. Such a system “is not one which is naturally robust to claims for mis-selling”, said the FSA chairman.

While the last point implies that there is a counter incentive to insouciant sales-chasing, it is clear that the distribution system is in the FSA’s sights as part of the TCF initiative. In November 2006, it identified five themes to be addressed by a Retail
Distribution Review, headed by practitioners (it is to be hoped consumer representatives are amply consulted on this, along with more independent input):

- The sustainability of the sector
- The impact of incentives
- Professionalism and reputation
- Consumer access to financial products and services
- Regulatory barriers and enablers

Customer information about commission
The working group shares the chairman’s unease with the commission system, but in the absence of consumer willingness to pay for advice, it is hard to find an alternative to the provider remunerating the distributor. Allowing a profit margin to the intermediary is a universal part of business, but the problem in financial services is that the consumer is sometimes not in a position to make an informed choice. The first line of defence against mis-selling, and mis-buying, is the provision of clear information about the product, including its costs. This must include all commission levels, as well as other charges. Disclosure should generate market solutions. Annual fees for managing investments are bound to be more competitive if they are revealed. Some distributors might charge a flat-rate commission for certain product families, like an estate agent.

Read and understood
For riskier products – for instance, long-term saving for a pension where the outcome is uncertain – an appropriately trained salesperson takes the prospective customer through all elements of the product description. The customer should sign the following: “I have read and understood this description of the product, its risks and costs, and I am happy that it suits my circumstances.” A box-ticking exercise may actually help here by getting the customer to tick a box after each of the main points: what the product is; what the risks are; what it costs – with explicit recognition of the level of commission that the salesperson will earn; and that he or she is the sort of customer the product is aimed at. This would also help the salesperson complete the process correctly.

The definition of an “independent” adviser
In a commission-led environment, the concept of independence is a slippery one. The term independent financial adviser applies to those who are neither in-house salespeople nor involved in an operation with multi-ties to selected firms. But it does not mean that the adviser is primarily fee-based. The main point is that the adviser must act unequivocally as the client’s agent, not the provider’s. One way to do this is for the client to agree the charges and the payment schedule with the adviser. Qualifications are obviously another important element, and the standards-setting bodies would be in a good position to review the rigorousness of professional examinations for IFAs, as well as the way codes of professional ethics are applied.

After sales follow-up
Both providers and distributors of products need to have random testing procedures as part of their after sales follow-up. The quality control process should be sensitive to commission levels and to the links between sales levels and bonuses.
Recommendations

- Minimum standards should require a short, clear description of what the product is, who it is aimed at, the risks and all costs. Service standards should clearly set out what the customer can expect [see appendix 5: APCIMS].
- Particular attention should be given to the explanation of risk. For some product families a voluntary system of risk labelling might be helpful.
- Consumers should be willing to sign “I have read and understood” statements in a form approved by one of their representative organisations.
- The definition of independence as applied to financial advisers should be part of the retail distribution review with the aim of ensuring that the IFA is acting unequivocally for the client, not the provider.
- The system of training and qualification for those advising on purchases of financial products and services should also be reviewed.
- Product providers should conduct after-sales follow-ups on a sample basis.

The Prevention of Financial Crime

The regulatory burden on British financial and professional businesses has increased dramatically in recent years in part because of the requirements on firms to combat money laundering, financial crime and, latterly, terrorism. These involve demanding procedures for identifying customers and owners of assets and for providing information about counterparties, combined with extensive obligations to report suspicious transactions. It is easy to understand the motives that drive politicians and officials to leap at the opportunity to impose such additional measures in the heat of a crisis. It is equally easy, alas, for the same politicians and officials to neglect to subject the resulting compliance and other costs to any kind of careful analysis in the longer term, in collaboration with market participants. So there is much to be gained by applying the same cost-benefit and risk-based philosophy to these measures as is applied in other areas of financial regulation.

Simplification of these procedures is no easy matter, however, because of the many institutions involved, which include:

- Global: the Financial Action Task Force (FATF) of more than 50 member nations, which is driving forward initiatives to which lower level organisations have to respond or conform. IOSCO and the Basel committee are also involved in some aspects of policy.
- International: any EU member will also have to conform with the requirements of the Community.
- National: in the UK
  a. Parliament has passed several laws dealing with money laundering, the proceedings of crime and terrorism prevention. In addition, the FSA – and other regulators – have introduced certain rules, regulations or guidance to give effect to all the above, or to enact provisions appropriate to the UK’s special circumstances.
  b. In 2006, the Serious Organised Crime Agency (SOCA) was formed by merging the National Crime Squad, the National Criminal Intelligence Service and parts of Revenue & Customs and the UK Immigration Service. SOCA is an intelligence-based agency with law enforcement powers which, among other things, implements the “Suspicious Activity Reports” regime. SOCA is expected to absorb the Assets Recovery Agency shortly.
Market participants: the Joint Money Laundering Steering Group (JMLSG) has long provided market-based expertise to shape guidance through the financial sector.

The multiplicity of players, combined with the revolution in telecommunications and globalisation of markets, has brought serious problems to the fore. First, there is growing inconsistency and, hence, costs for the markets arising from the lack of co-ordination internationally. Second, there are inconsistencies within individual countries when the requirements of the different players tangle. These problems are not, however, irremediable.

In the UK, the JMLSG reviewed its 2003 industry guidance in February 2006. The review coincided with the FSA’s announcement that it was replacing its ML Sourcebook with “High Level Standards”. The revised guidance, which cut the number of pages of regulation from 57 to 2, took effect on 31 August 2006.

The steering group comprised representatives of 16 trade associations as well as consumer bodies, the Government and regulators. It reviewed the guidance with a view to allowing firms “to counter money laundering and terrorist financing in a more proportionate, risk-based way, making better use of modern technology”.

According to the London Investment Banking Association (LIBA): “Sitting at one table with representatives of all major stakeholders allowed us to focus on real issues and to understand better what was expected of the industry by the Government and regulators.” Another advantage was “engagement [with the regulator] and trust that the industry was now mature enough to take responsibility for operational matters”.

The CSFI working group believes this model could be applied more widely for the formulation or review of financial services regulation within individual countries. Internationally, consultation and collaboration with market participants are still in their infancy, but could also play a decisive role in improving matters.
CHAPTER 3: IMPLEMENTATION

The process of adding layers to regulation does not end with formulation. It is often at the implementation stage, where it is made clear how a new law affects business practice, that prescription and complexity are increased. The working group starts from the premise that this process, often termed “gold-plating”, is a bad thing because regulation should be kept to a minimum. The scope for such accretion seems to increase with the remoteness of the original law-making, hence the UK’s preoccupation with the implementation of EU directives. The Foreign Policy Centre, a think-tank backed by Tony Blair, working with the Federation of Small Businesses, found unnecessary gold-plating of five of the eight directives it examined, among them the Insurance Mediation and Money Laundering Directives. The findings, published in September 2006, were that the scope of the legislation had been increased by, for instance, adding requirements and introducing targets and deadlines.

What national activity at the implementation stage recognises is that the policy-making front-end of setting regulation has often moved to a different level. Primary responsibility for arguing the UK’s case in Brussels for business friendly legislation lies with the UK government, notably the Treasury, which must have sufficient ministerial leadership, resources and continuity of staff to do this effectively.

Back at national level, the potential harm done by the addition of local requirements is recognised in the Markets in Financial Instruments Directive (MiFID). Article 4 seeks to limit member states’ freedom to add obligations at the national level. The FSA has recognised that this also means reviewing existing rules to see whether they go beyond the requirements of the Directive and, if so, questioning their retention. The assumption must be that they will be scrapped unless a justification exists that is as strong as that which would apply to new regulation. Evidence of such barnacle-scraping has come in the “NewCOB” rewrite of sections of the FSA Handbook affected by MiFID, halving the number of pages.

The mirror image of gold-plating is carve-outs, exemptions or partial adoption of cross-border regulation designed to supersede national regimes. The French won a carve-out from IAS39, the accounting standard on derivatives, for their banks; the British have an exemption from the EU Working Time Directive that allows workers to opt out of the 48-hour limit on the working week; the US is only implementing Basel II for its largest banks. Such spanners in the works prevent cross-border legislation from delivering its single-market – or international harmonisation – goal of levelling the playing field for business. But since such exemptions are often temporary and tend to hold down business costs, the working group was less concerned about them than about gold-plating.

Accretions to original legislation come in four main forms:
• National (or other local) rules: This is where domestic regulators either add to rules set by a higher, or cross-border, authority such as the EU, or do not repeal old rules that should be superseded by international ones. These extra requirements are sometimes defended as maintaining an old regime that is regarded as better than the new one. The difficulty for business is that it
may end up with requirements that do not weigh on competitors elsewhere, and an opportunity is lost to enjoy lighter touch regulation.

- National or international codes of practice: An important distinction must be made between mandatory requirements imposed by a domestic regulator and codes of best practice, where compliance is voluntary. A prime example is the UK’s Combined Code on Corporate Governance, which has been developed by independent review, with Higgs as the latest, but then revised and adopted by Financial Reporting Council. Companies are, however, obliged to comply or explain.

- Voluntary industry codes, such as the Banking Code, which sets minimum standards for the way in which banks, building societies and other banking service providers treat their customers. These codes are not statutory, but more like the rules of a club. The bodies that set them may be relatively independent from the industry: the Banking Code Standards Board has a majority of independent directors, for instance. Pressure to comply comes from monitoring of members’ activities and sanctions, such as “naming and shaming” or expulsion.

- Self-imposed additions by individual firms that are worried about compliance. This may happen through ignorance of what, for example, a European Directive actually says, or it may be the deliberate policy of a conservative management or one that is rebuilding a firm’s reputation after a transgression.

**Bureaucratic motivation**

Taking the EU as an example, there are many reasons, including legal and psychological factors, why a member state may wish to tailor the implementation of a Directive, or seek a carve-out. But no exemption is won without ground being given elsewhere. The UK’s opt-out from the Working Time Directive was achieved at the expense of watering down the Takeover Directive, for instance. Since the working group’s presumption is that gold-plating is to be avoided, only the first two in the following list are justifiable on the basis of minimising the impact on business and competition.

- To provide a way round features of a Directive regarded as being extremely bad for business, such as the 48-hour limit on the working week.
- To satisfy the desire of market practitioners to maintain provisions that work well and no one wishes to replace. An example of this is the minimisation of the impact of the Takeover Directive on the flexible operation of the Takeover Panel.
- To provide operational certainty where a Directive text is not prescriptive. The UK legal framework’s dislike of vagueness may lead to unnecessary additional specifications.
- To provide a gold standard rather than the minimum legal requirement, or where there is a regulatory gap. The UK’s lead in corporate governance regulation is an example of this.
- Over-zealous implementation: this comes in a number of forms including the regulator’s desire to implement fully and promptly rather than to minimise the impact on business; and the vested interests of lawyers, accountants and other compliance advisers.
- To create barriers to competitors, whether domestic or international.
Recommendations

At national level:

• National regulators should generally not add compulsory requirements to rules set by supra-national authorities. The guiding light should be what is best for cross-border business – including harmonised or uniform regulation – not what justifies the existence of domestic regulators.

• National or local rules that are superseded by the new cross-border ones should be repealed. However, if there is an existing practice that is (by consensus between the industry and the regulator) regarded as too good to change, such as the Takeover Panel, it should be accommodated with as little disruption as possible.

• It must be assumed that legislation that would harm UK business will be fought at a political level in Brussels, or wherever supra-national regulation emanates from. The Treasury plays a key role in this and must deploy sufficient resources. The FSA exerts influence through technocratic bodies such as CESR and IOSCO.
• There may be rare occasions where UK business interests would be so
damaged by an EU Directive that it is worth seeking to negotiate an opt-out,
as with the Working Time Directive, with the caveat that the price extracted
for the exemption is worth it.
• The UK should beware of adding verification requirements or enforcement
procedures to those required by Directives, or other internationally agreed
regulation.
• Where the UK has developed a guide to best practice, such as that on the
Operating and Financial Review, it should be voluntary. Setting out best
practice should not be the goal of statutory regulation.

At industry level:
The remedy to gold-plating also lies in the hands of companies and their trade
associations. Clearly, they must be vigilant in looking out for requirements that will
damage business and erode the UK’s competitiveness, and then focus on lobbying
effectively. But they must also beware of becoming part of the problem by inviting
more detailed and prescriptive regulation in their search for certainty of interpretation.
The spirit of the law, or the principle behind it, should more often be used as a guide.
• Management should treat advice from experts as just that – to be accepted or
rejected as risk assessments that inform, but do not inhibit, development of
the business. It may, for instance, be a marketing decision to go further than
minimum regulatory requirements.
• The temptation to protect vested interests or discourage competition must be
resisted.
CHAPTER 4: ENFORCEMENT

Since the FSA gained its full powers under the Financial Services and Markets Act on 1 December 2001, its “risk-based” approach has delivered fewer but bigger financial penalties. This change of policy complicates comparisons with previous regimes, as do the increased enforcement powers in such areas as market abuse, insider dealing, money laundering and mortgages. The rush to clear cases before the new legislation took effect also exaggerates the drop in the number of fines post 01.12.01.

Less is more

Nevertheless, it is clear that the impact has been much as the FSA planned. The number of fines imposed has at least halved, falling from more than 70 in both 2000-01 and 2001-02 to between 16 and 34 in the five subsequent years. But the average fine has shot up. During the effort to clear small cases in 2000-01, the average was £74,000. By 2004-05, which included the record £17m fine on Royal Dutch/Shell for market abuse, it was nearly 10 times that at £718,000, and in 2005-06 it topped £1m. If you exclude outlier penalties such as the one on Shell or the £13.9m imposed on Citigroup the following year, the average is roughly three times higher than in 2000-01. For 2006-07, the average ex-Deutsche Bank (£6.36m for market conduct and due skill and care offences) was about £260,000. [See chart.]

The working group is broadly in favour of fewer fines with large exemplary penalties for wrongdoing that causes significant losses, particularly to vulnerable investors in public markets. Oddly, the Citigroup trading coup, which disrupted the EU government bond market, did not affect the vulnerable directly. The largest fines have tended to be for public market manipulation or obstructing regulators. While one or two members believe that fining is so rife the impact has been diluted, most feel that the reputational damage, while very hard to quantify, is a big deterrent even if the fines remain small relative to the profitability of the companies involved, and relative

---

Figures in lefthand scale in £

Source: FSA
to the big stick wielded by the SEC. The Commission fined Shell US$120m, for instance. One member said: “The [fine] amount is almost irrelevant. If you get to that point, i.e. enforcement, it’s a bad place…it’s a market cap event: you pay in the share price.”

The individual deterrent

There is also some support for pursuing individuals with as much vigour as companies, although the FSA’s record on this – like that of other regulators such as the Serious Fraud Office – is patchy. A recent (October 2006) example of a failure on this front was the finding, by the independent Financial Services and Markets Tribunal, that the FSA had acted unreasonably in the unsuccessful market abuse proceedings it brought against Paul Davidson and Ashley Tatham.

One working group member did express strong reservations about pursuing individuals, saying that it could amount to “blackmail” in that “they move against individuals to make the company cave in”. But this was not the general view. Most felt that directors and senior managers should have clear incentives to ensure that their company did not abuse customers or mar the working of markets. Yet even the extreme view concurs with the belief that pursuing individuals has a particularly strong deterrent effect. If the message is that senior people should take full responsibility for their companies’ actions, the FSA needed some more important scalps than Davidson and Tatham, even before the humiliating reversal of that case. It tried in the wake of the Shell market abuse fine to pursue Sir Philip Watts, the former chairman, but this came to nothing.

In 2006, however, it did deliver on its intent with £750,000 fines of both GLG Partners, one of Europe’s largest hedge funds, and Philippe Jabre, a former managing director of GLG. The offence was market abuse over convertible bond deals and Jabre’s fine was the largest the FSA had imposed on an individual. Jabre’s reaction was to set up a new fund in Geneva, beyond the FSA’s jurisdiction but not beyond the reach of clients with mobile money. By 21 December 2006, the day his new fund opened to investors, he had recruited a team of 20 and was aiming to raise US$2.5bn. Nevertheless, the twin penalties for GLG and one of its leaders signal the way the FSA is moving in terms of enforcing individual as well as corporate responsibility.

The question is whether there are sufficient checks on its powers of prosecution. Its setbacks, whether they be from the tribunal or its own withdrawal of incomplete cases, offer some reassurance on this count, as do the reforms that followed the Enforcement Process Review [see appendix 3], led by David Strachan in the wake of the tribunal’s censure of the FSA in the Legal & General case. Concerns remain, however, about the adequacy of the separation of FSA powers as prosecutor and judge.

Principles-based enforcement

Both GLG and Jabre were fined for breaches of FSA principles; so were Citigroup and Deutsche. While punishment on the basis of principles alone has been applied in only a handful of cases, John Tiner, FSA chief executive, spelt out the regulator’s intent at a conference in June 2006 on enforcement: “I want to emphasise today that
we can and do take enforcement action on the basis of principles alone and it is our intention to go down this route.” Bearing in mind that the Treating Customers Fairly initiative is based on enforcing a principle, a key test of the FSA’s ability to manage principles-based supervision fairly will be the disciplinary outcome. Will there be naming and shaming? Will persistent offenders or laggards face heavy penalties? And will senior individuals be pursued as well as companies? So far the approach has been one of discussion with the industry, guidance in various documents and speeches, general comment on progress and plenty of exhortation. The FSA has said it wants to see “measurable change in outcomes for consumers” during 2007. In other words, it is early days in terms of enforcement of TCF, but it will provide an acid test of the workability of both principles-based regulation and principles-alone enforcement.

The dangers in the principles-alone approach are that it is:
- uncertain because no clear-cut rule is broken;
- an enforcement short-cut because the FSA does not have to show that specific rules have been broken;
- a catch-all: “treat customers fairly” is like saying “be good”;
- an effective addition to all those rules in the 8,500-plus-page Handbook.

Recommendations
The working group supports the FSA in its pursuit of cases on the basis of principles alone. This is one clear way to focus directors’ and senior managers’ minds on the principles that underlie all the rules and on their accountability for ensuring their businesses comply with those over-riding standards. But there need to be some checks on this broad-brush approach:
- Predictability: reviews of conditions prevailing at the time must have a strong independent element. Tiner has said: “It must be possible to predict, at the time of the action concerned, whether or not it would be in breach of a principle”. The danger is that a regulator’s interpretation can change not only with hindsight but under public and political pressure.
- Where possible the FSA should show breaches of specific rules as well as principles to reassure its constituents that it has collected substantial evidence.
- Transparency: for action on the basis of principles alone, the FSA should be explicit and transparent about its reasons for taking action. It should also publish the contrary arguments adduced by the board of the regulated entity.
- The Financial Services and Markets Tribunal should routinely review enforcement actions on the basis of principles alone. It could do this, initially, on a private pre-hearing basis to establish whether the need to clarify the legal issue warranted a public hearing (the normal modus operandi for the tribunal). Its public decisions, apart from endorsing or modifying the FSA’s approach, would also provide guidance to the industry.
- An annual report, produced by the FSA and the tribunal, could point up lessons to be learnt from enforcement action involving breaches of principle.

The drive to settle early
The FSA is a believer in early settlement. Margaret Cole, director of enforcement, addressed the notion that speed may ride roughshod over fairness at the 2006 enforcement conference [see appendix 3]. She said: “Speed is not just about effectiveness or efficiency. In fact it is also an essential component of fairness.” The
advantages of speed, which she tended to equate with efficiency, include that the memories of those involved are fresh, that the cost, pressure and inconvenience to the firm concerned are minimised, that anyone harmed receives restitution as quickly as possible and that lessons can be learnt promptly. Important disadvantages are the lack of transparency and clarity. The very fact that it is a pragmatic negotiation, rather than an independent judgment of the case on its merits, means that lessons will be more difficult to draw than they would be from case law.

The disadvantages are exacerbated by discounts for settling early. This makes it even less likely that a company will feel it is worth fighting a ruling through the FSA’s Regulatory Decisions Committee to a public hearing by the tribunal, and maybe even the court of appeal. This lack of transparency is of particular concern when the regulator is changing its philosophy, as the FSA is in its drive towards principles-based enforcement.

The danger is that a firm will pay up simply to settle quickly and at limited cost, even when it believes it was in the right. This engenders cynicism: some working group members talked of firms paying the regulator to go away and regarding penalties as a cost of doing business. To counter the cynics, it is worth noting that the cost of settling early may be under-estimated since the firm’s opportunity to put its case is curtailed and a precedent is established in the FSA’s favour.

However, the authority seems to be largely in tune with business on early settlement. Practitioners in the working group supported the opportunity to arrive at pragmatic settlements, in private, with the minimum of time and resources being soaked up. Other alternatives, involving mediation or arbitration by third parties, also point to the popularity of negotiated settlements, rather than using disputes as material for public development of case law. Settlement also often allows the firm concerned to avoid an admission of guilt. The regulator similarly seems to prefer the negotiated route rather than having its decisions challenged publicly before the tribunal, whose criticisms have embarrassed it.

The separation of powers

Nevertheless, the need to make the process seem fair – and to counter cynicism – suggests that two areas deserve further scrutiny. The first relates to the semi-autonomy of the Regulatory Decisions Committee (RDC), which takes enforcement, authorisation and supervisory decisions that are of material significance to firms and individuals. Its independent resources were beefed up as part of the welcome reforms that followed the Strachan review (an FSA review of its procedures, not an independent body’s). But it is still not seen by some as being independent enough from the FSA, of which it is a board committee. The RDC enables decision-making on enforcement action to be done separately from the investigation of the alleged wrongdoing. However, the FSA appoints the RDC’s members and houses it in its offices. And the RDC’s remit does not allow it to question FSA policy: it looks at whether the FSA has acted correctly within its own policy and standards. The second issue is that RDC members, even when they have worked for companies,
tend to have a legal/advisory or regulatory/public policy background, rather than up-to-date experience of running a business.

Recommendations

- The RDC’s remit should be reviewed to examine whether it should have more latitude to question FSA policy.
- The RDC should be physically independent, with its own offices and adequate, non-FSA support staff.
- The appointment procedure should be reviewed. Assuming the RDC remains answerable to the FSA’s board, that board will need to appoint the chairman. But the chairman should then lead a fully independent appointment process.
- The job description for RDC members should place more emphasis on recent, operational business experience.

Feedback

A valuable addition to the enforcement process since October 2005 is that firms and individuals have the opportunity to give feedback at the conclusion of enforcement cases. They should seize this chance to suggest how the FSA might perform better, and the standards-setting bodies should see the feedback from their sectors. The FSA publishes a summary of the main issues and lessons learned from this exercise in the Enforcement Annual Performance Account alongside its annual report.

Intrusive supervision

Having expended all these words on enforcement, it is worth remembering that it only takes up 11-12% of the FSA’s budget. A bigger issue is intrusive and process-driven supervision, in which about 1,200 of its 2,800 staff are involved. “Arrow” (the advanced, risk-responsive, operating framework) is described by the FSA as being at the heart of its risk-based approach to regulation. Arrow was reviewed in 2003 and since 2004 has been redesigned under a programme known as Arrow II. The regime deals with firms according to size and perceived risk. Its categories in terms of the supervisory regime applied are: small firms; Arrow light, mainly for medium-sized businesses; high-risk medium-sized firms; and large firms, usually part of groups.

Supervision ranges from analysing small companies’ returns to “close and continuous” assessment, where the business has frequent contact with the FSA [see box 1].

A frequently expressed complaint about FSA supervision from firms of all sizes is that it is process driven, which places a weight of routine demands on firms for information and documentation, in addition to the need to keep up with the regulator’s output. This suggests that a culture persists of relying on and enforcing detailed rules, that staff have insufficient industry knowledge, and that there is insufficient trust between regulator and regulated. The move towards principles, risk-based and proportionate regulation has prompted a reduction in routine contact and placed a greater onus on firms to seek guidance when they need it, via the small firms’ helpline, for instance. But to make this work well requires a change in the quality of the dialogue between the two sides.

By international standards, the average UK firm – most of which are relatively small – is subjected to relatively few routine visits. According to the FSA, the average length of time between Arrow inspections is 32 months and for most firms the visit lasts
one day. The same applies to reporting. It cites the example of the Committee of European Banking Supervisors’ (CEBS) proposals for common reporting related to solvency under the Capital Requirements Directive (CRD) and consistency of implementation by European regulators. CEBS proposed the collection of 22,200 data items, whereas the FSA will only collect 1,290 data items, less than a tenth of its typical continental counterpart. This is not to say that all routine reporting is bad. In its absence, ad hoc requests for information can be more disruptive because collection is not systematic. As usual, the issue is one of striking the right balance.

One way to gauge this might be to require regulators to tell firms what happens to the reports they produce as part of compliance procedures: what percentage were followed up and what proportion of those led to action or recoveries for customers. There is a need for transparency on both sides and for a willingness on the part of the authorities to simplify requirements where no action is being taken on the bulk of reports.

Do those responding to firms’ queries have the authority and confidence to exercise judgment?

One way to gauge this might be to require regulators to tell firms what happens to the reports they produce as part of compliance procedures: what percentage were followed up and what proportion of those led to action or recoveries for customers. There is a need for transparency on both sides and for a willingness on the part of the authorities to simplify requirements where no action is being taken on the bulk of reports.

The FSAs planned staff cuts, coupled with the flexibility to pay more to staff exhibiting greater skill and initiative, reflect this trend towards what might be called “quality time” with firms, rather than sheer quantity of contacts. This has important implications for staff training. Do those responding to firms’ queries have the authority and confidence to exercise judgment and give constructive advice? How
will they fill in the gaps for interpretation in a reduced Handbook? This training challenge will to some extent be mirrored within firms, where staff will more often be expected to apply a test of principle because the Handbook may not cover their specific detailed queries.

In terms of retail conduct of business, the devolution of regulatory duties to sector standards setters should include the threshold of supervision, including industry intelligence. The Banking Code Standards Board, for instance, requires an annual statement of compliance from subscribers, visits firms and conducts market research and mystery shopping. A beefed-up standards-setting body, under the FSA umbrella, could operate like this, referring evidence of problems to FSA investigators. Information from sector standards setters could be fed into the FSA’s thematic work, which focuses on activities identified as having the potential to damage markets or harm consumers. This is the supervisory equivalent of switching from detailed prescriptive regulation to a principles-based regime. But it will only reduce the overall burden of regulation if it reduces process-driven supervision.

It is worth recalling some of the key recommendations of the Hampton Review: inspections should have a purpose; businesses should not have to give unnecessary information; regulators should provide authoritative, accessible advice. This means re-orientating supervision towards outcomes, rather than monitoring process. In one sense this demands a more reactive role: responding to genuine evidence of harm, such as complaints to the Ombudsman that suggest a pattern of customer abuse. In another, it encourages pre-emptive action where potential harm is identified, through specific guidance and early warnings to potential wrongdoers – jumping on advertisements that suggest a product is low risk if capital may be lost, for instance.

**Recommendations**

- The FSA should continue to refine its risk assessment process. Doing that better, as Hampton notes, would provide a basis for cutting staff and switching some of them from routine activity to the provision of advice.
- More regulatory resources should be focused on improving outcomes by investigating complaints and by mystery shopping.
- The FSA should as a minimum implement the 10% staff cut proposed by its chief executive. Staff switched to sector standards setters would obviously not count as cuts. Increased sector knowledge and greater use of co-opted practitioners and consumer representatives should make it easier to spot problems with fewer staff.
- Standards setters should try to nip problems in the bud by giving firms advice or issuing public warnings to the sector. Evidence of breaches of principles or rules would, of course, be referred to the FSA for investigation.
CHAPTER 5: CONCLUSION

Since the working group first met in early 2006, the FSA has moved to tackle several of the concerns that prompted it. This has been fuelled by a growing pile of evidence of the cost of regulation and by the rightful emphasis on fair outcomes for customers. Nevertheless, there is no doubting the heavy burden, particularly on the retail side; nor is there any doubt that the industry, particularly in Europe, has been bogged down by a combination of national and international regulatory initiatives.

The self-denying regulator

Part of the answer is closer co-operation between regulators to deliver co-ordinated and compatible benefits that justify the cost of change. But there also needs to be a cultural change away from the legalistic mindset that spawns detailed, prescriptive rules and encourages defensive over-compliance by firms. A principles-based approach, which is often praised in theory but shied away from in practice, leaves more room for market-orientated solutions, places responsibility for a business’s behaviour squarely on its management and enforces the spirit of the law as well as the letter.

Bearing in mind all the pressures that lead to regulatory change, from local reactions to scandals to global moves towards common standards, regulators need to impose a self-denying ordinance. Less activity can have more impact in three senses:

- In wholesale markets, where professional practitioners need little protection and market forces are well oiled, the consensus is that light-touch regulation (not to be confused with soft enforcement) is all that is necessary. Indeed, anything more can drive mobile capital away – hence, the fears being expressed by practitioners-turned-politicians in the US.
- There should be no gold-plating. National or other local regulators should not only resist the temptation to add to cross-border rules, such as European directives or international accounting standards, they should also repeal legacy regulation.
- Regulation should be principles-based, but where these high-level edicts need clarification, this should be via minimum standards. The goal of regulators should not be to drag every operator up to the level of the best.
The FSA remains a work in progress, even though many observers reckon it is the best of the regulatory bunch internationally. The challenges that lie ahead include continuing to improve the quality and judgment of its staff. With a 10 per cent reduction in headcount already proposed, the “less is more” theme may signal a way to make a virtue of necessity. Related to this is the need to retrofit knowledge of the industry and the way markets work into a regulatory process that has swung far away from self-regulation. Coupled with the industry’s acknowledgment of its responsibility for implementing principles in practice, the time is ripe for passing more regulatory responsibility to sector standards setters. Inclusion of consumer representatives should ensure the focus remains on positive outcomes for that constituency; and the inclusion of other experts in the field would lend independence.

With those affected by regulation more intimately involved in the process, plenty of scope remains to improve the approach to new regulation, to slim down legacy rulebooks and to supervise the financial services industry in a less intrusive but more effective way.
APPENDIX 1

Measuring the problem

Measuring the cost of regulation, let alone the benefit, is notoriously difficult but the level of complaint from business about over-regulation, or “red tape”, reached such a pitch a few years ago that the government started to pay attention. The Better Regulation Taskforce’s report “Regulation – Less is More” and the Hampton Report on “Reducing Administrative Burdens” both came out in March 2005 [see appendix 4]. While they covered the business waterfront, the conclusions were as relevant to financial services as to other industries. Gordon Brown, Chancellor of the Exchequer, accepted the recommendations of both reports, which included:

• Measuring administrative burdens and setting targets to reduce them
• A one-in, one-out approach to new regulation
• Enforcement should be based on risk assessment
• Regulators should divert resources from unnecessary inspections to advice
• There should be fewer, simpler forms

In March 2005, the FSA and the Financial Services Practitioner Panel commissioned Deloitte to carry out a study of the cost of regulation under the Financial Services and Markets Act (2000). This was in response to the burden of regulation being the single biggest concern in surveys conducted by the panel. The latest FSPP survey, published in November 2006, again found that practitioners perceive the cost of compliance with regulation to be excessive.

The Deloitte study, published in June 2006, covered 68 firms in two wholesale sectors and one retail. The results confirm the view that UK regulatory costs are, proportionally, much higher in retail financial services than in wholesale. In corporate finance, the majority attributed less than 2% of their total costs to FSMA regulation; the top estimate was less than 5%. In institutional fund management, the top estimate was more than 7%, with about half above 2%. But in investment and pension advice, the bottom of the range was about 2% and the top more than 35%, with the majority between 5% and 15%. The figures represent the adding together of the incremental costs that firms attributed to individual rules and so might include some double counting. They do not take account of the fact that firms might continue with activities attributed to regulation even if the rules were not there. And the disparities indicate, among other things, differing judgments as to what the incremental costs were as well as over-compliance by some firms.

The Deloitte study preceded the Markets in Financial Instruments Directive, which the FSA has estimated will cost 2,500 UK banks, exchanges, fund managers and stockbrokers £887m-£1.17bn to implement. Ongoing costs are likely to be £100m a year, while benefits are put at about £200m. Other surveys have weighed in with higher estimates. The think-tank Open Europe, working with Keith Boyfield Associates, found that estimates of the total costs (one-off and annual ongoing) of MiFID in the UK by 2010 ranged from £1.2bn to £6.5bn, as part of grand total of £14bn-£23.5bn for the FSAP as a whole [see appendix 2].

One of the most puzzling reasons for the variation in estimated costs is over-compliance. The working group felt this was symptomatic of a lack of trust between the regulator and the industry, leading to risk aversion on
Fourth Survey of the FSA’s Regulatory Performance
Commissioned by The Financial Services Practitioner Panel from GfK NOP
November 2006

The Financial Services Practitioner Panel (FSPP) was established in November 1998 and derives its statutory basis under s.9 of the FSMA. Its aim is to be a high-level body available for consultation on policy with the FSA and able to communicate to the FSA views and concerns of the regulated industries.

The 2006 research programme focused on the following:
• to provide top-level assessment from chief executives/principals on their perceptions of the performance and areas of priority of the FSA
• to provide industry-wide views on the operational efficiency of the FSA in dealing with firms
• to provide the Panel with information on the effect of the FSA on the industry (in areas such as costs, innovation and competitiveness)
• to provide information which can be used by the Panel in suggesting to the FSA how it should set its priorities and guide delivery of its operations
• to provide a basis on which to track and compare the effectiveness of the FSA over time.

The report was based on a survey of 4,071 senior executives in regulated financial services firms. ‘A qualitative study was also undertaken- involving more than 50 firms from across all sectors and sizes of business - to help provide depth and to aid the development of the quantitative work.’

General attitudes towards regulation
The qualitative study showed that many practitioners believed the burden of regulation had increased since the third FSPP report in 2004. This was attributed to constant changes to the regulatory regime, coupled with a lack of information, clarity and trust, which added to the pressure on firms. Many firms found it difficult ‘to fully digest regulation and achieve a sense of stability.’ Smaller firms felt this pressure more than big firms.

The burden was also felt more by retail firms than wholesale firms, as in 2004, and the qualitative study found ‘genuine concern that the situation had failed to improve over the last two years’. Strong concerns were also voiced about the regulatory burden being detrimental to consumers’ interests and some retail firms (over one fifth of the firms surveyed) said they were seriously considering leaving the industry as a result of the cost of compliance. Practitioners thought that principles-based regulation (PBR) added to the burden and discontent. Although most firms welcomed the concept of PBR as opposed to rules-based regulation, it was felt that the FSA did not make it clear enough how the concept would work in practice. Likewise, many firms welcomed the Treating Customers Fairly (TCF) initiative, yet over half of the practitioners surveyed felt that the FSA had failed to provide a clear explanation of how firms should implement TCF.

Costs and efficiency
The cost of compliance was a major issue in the 2006 survey and was deemed once again excessive both in direct and indirect terms. However, fewer practitioners believed that the cost of compliance would continue to rise for the foreseeable future, but a large majority of practitioners still felt that the current costs of compliance were harmful to their business.

‘A sizeable proportion of practitioners also…felt their business was placed at a disadvantage when competing for international business as a result of the costs of compliance…When asked to estimate the costs of compliance as a proportion of total costs, nearly one fifth of all practitioners and nearly one quarter of those from smaller retail businesses, stated that compliance costs were 15% or more of total costs. Over one in ten smaller retail firms claimed that this proportion was 25% or more.’
Statutory objectives
Practitioners continue to give high ratings to the FSA on its performance against its objectives for reducing financial crime and securing the right degree of protection for consumers. However, the FSA was also thought to have focused on consumer protection to the detriment of its other objectives. Practitioners believed that the FSA lacked a balanced approach and was acting in a disproportionate manner in this area.

The 2006 survey revealed an improvement in the FSA's performance in maintaining confidence in the UK financial system but scores continued to be low for the promotion of public understanding of the financial system.

Overall effectiveness of the FSA
Regulatory fees paid by practitioners were considered not to be value for money and this was especially felt by small firms. Many practitioners still felt that the FSA had a ‘one size fits all’ approach to regulation.

FSA developments
The qualitative study showed some recognition that the FSA's approach to smaller firms had slightly improved, following the establishment of the Small Firms Division. Some 52% of firms agreed that the FSA industry training roadshows and events were an effective means of disseminating information. Practitioners were particularly pleased to be able to access the Handbook and to file reports online. The Retail Mediation Activities Return (RMAR) was felt to contribute in a major way to the extra burden felt by retail firms. Smaller firms in particular were struggling with having to report twice per year instead of once.

EU and international issues
Practitioners did not feel that EU and international issues were a major concern, especially for smaller firms which were primarily UK based. Major groups and wholesale firms felt international issues to be a top priority. A number of voices were also raised about the FSA gold-plating EU Directives and as such putting UK firms at a commercial disadvantage in Europe.

Overall satisfaction
The average score was 6 out of 10, the same as in the 2004 survey. The main areas where improvement was considered a priority were:

- Supervisory approach and business understanding – Practitioners felt that high staff turnover at the FSA meant that little understanding and corporate memory had been developed. The understanding of practitioners’ business by FSA staff was the main priority for improvement.
- Staff knowledge and consistency – The provision of guidance in relation to staff knowledge and consistency was very poor. Any improvements in the approachability of FSA staff were felt not to have reduced the regulatory burden.
- Handbook – Although the handbook had greatly improved over the last two years, many found that it was still difficult to find the rules and guidance needed.
- Effective administration – Most practitioners felt that the FSA was relatively good at carrying out processes such as authorisations and approvals but the standard was still not satisfactory.
- Open discussion – Generally, it was felt that it was possible to be open and frank in discussions with the FSA but many practitioners continued to feel they could not work through things informally without involving legal experts.

Conclusion
Wholesale firms have a more positive view of the FSA, compared with the previous survey, but in the retail sphere the discontent had deepened. Areas of major concern were PBR and TCF where the industry was looking for clearer information on how it would work in practice. Firms were keen to have a period of stability to allow efforts to focus on ensuring that existing initiatives worked effectively.

Banking Banana Skins 2006
David Lascelles, Senior Fellow, CSFI

This long-running survey conducted by the CSFI, with the support of PricewaterhouseCoopers, aims to plumb the views of nearly 500 financial practitioners and analysts around the world and compiles them into a league of risks.

In 2006, excessive regulation topped the list of the Banking Banana Skins for the second year running and the impression was that things seemed to be getting worse. Too much regulation is a rather odd risk: after all, regulation is
supposed to be about reducing risk rather than creating it. But too much regulation can generate risks in many ways.
One is simply by adding burdens of cost to a business. Compliance is expensive and keeping on top of regulation can
divert management from the more important job of running a healthy business.

But regulation also works in more insidious ways, for example, by encouraging firms to take a box-ticking approach to risk rather than thinking about it creatively. If you have covered all the bases, the temptation is to think you have got all your risks under control. Actually, the opposite is true. It merely means you have covered the obvious. But what about the risks no one has thought about?

The Banana Skins List may provide some useful pointers, but it cannot claim to be complete. What it does tell us is how the market perceives risk and where it is focusing. It therefore also tells us where the market is not focusing – it is quite useful to turn the list upside down and look at some of the low rankers that the market may be overlooking. Here, the obvious candidate is payment systems. If the market is really worried about the banking industry's high dependence on technology (ranked 6th), how is it so relaxed about payment systems that are enormously technology dependent? This is surely contradictory and suggests that more attention should be focused on payment systems.

### Banking Banana Skins 2006 (2005 position in brackets)

<table>
<thead>
<tr>
<th>Rank</th>
<th>Risk Description</th>
<th>2005 Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Too much regulation</td>
<td>(1)</td>
</tr>
<tr>
<td>2</td>
<td>Credit risk</td>
<td>(2)</td>
</tr>
<tr>
<td>3</td>
<td>Derivatives</td>
<td>(4)</td>
</tr>
<tr>
<td>4</td>
<td>Commodities</td>
<td>(14)</td>
</tr>
<tr>
<td>5</td>
<td>Interest rates</td>
<td>(12)</td>
</tr>
<tr>
<td>6</td>
<td>High dependence on technology</td>
<td>(8)</td>
</tr>
<tr>
<td>7</td>
<td>Hedge funds</td>
<td>(5)</td>
</tr>
<tr>
<td>8</td>
<td>Corporate governance</td>
<td>(3)</td>
</tr>
<tr>
<td>9</td>
<td>Emerging markets</td>
<td>(15)</td>
</tr>
<tr>
<td>10</td>
<td>Risk management techniques</td>
<td>(9)</td>
</tr>
<tr>
<td>11</td>
<td>Fraud</td>
<td>(6)</td>
</tr>
<tr>
<td>12</td>
<td>Equities</td>
<td>(18)</td>
</tr>
<tr>
<td>13</td>
<td>Currencies</td>
<td>(7)</td>
</tr>
<tr>
<td>14</td>
<td>Macro-economics trends</td>
<td>(10)</td>
</tr>
<tr>
<td>15</td>
<td>Political shocks</td>
<td>(22)</td>
</tr>
<tr>
<td>16</td>
<td>Conflicts of interest</td>
<td>(-)</td>
</tr>
<tr>
<td>17</td>
<td>Banking market overcapacity</td>
<td>(20)</td>
</tr>
<tr>
<td>18</td>
<td>Money laundering</td>
<td>(13)</td>
</tr>
<tr>
<td>19</td>
<td>Merger Mania</td>
<td>(27)</td>
</tr>
<tr>
<td>20</td>
<td>Legal risk</td>
<td>(17)</td>
</tr>
<tr>
<td>21</td>
<td>Business continuation</td>
<td>(19)</td>
</tr>
<tr>
<td>22</td>
<td>Retail sales practices</td>
<td>(23)</td>
</tr>
<tr>
<td>23</td>
<td>Insurance sector problems</td>
<td>(11)</td>
</tr>
<tr>
<td>24</td>
<td>Back office</td>
<td>(26)</td>
</tr>
<tr>
<td>25</td>
<td>Environmental risk</td>
<td>(28)</td>
</tr>
<tr>
<td>26</td>
<td>Management incentives</td>
<td>(21)</td>
</tr>
<tr>
<td>27</td>
<td>Rogue trader</td>
<td>(24)</td>
</tr>
<tr>
<td>28</td>
<td>Competition from new entrants</td>
<td>(29)</td>
</tr>
<tr>
<td>29</td>
<td>Payment systems</td>
<td>(25)</td>
</tr>
<tr>
<td>30</td>
<td>Too little regulation</td>
<td>(30)</td>
</tr>
</tbody>
</table>

### Selling the City Short?

A review of the EU’s Financial Services Action Plan

Open Europe in association with Keith Boyfield Associates

November 2006

The effects of the EU’s Financial Services Action Plan on the City

The Financial Services Action Plan (FSAP) is a hugely ambitious EU regulatory initiative, intended to create a single European market in financial services. This is a laudable aim, initially supported by many in the City. But the reality has fallen far short of the original objectives.

Open Europe estimates the FSAP will involve total costs to the UK economy of £14 billion - £23 billion by 2010, the symbolic “deadline” for the realisation of the Lisbon Agenda. This is likely to translate to around £40 billion - £70 billion (€60 billion - €100 billion) for the EU as a whole (see table overleaf).
Estimated costs of key FSAP measures:

<table>
<thead>
<tr>
<th>Directive</th>
<th>Estimated costs in the UK by 2010 (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts Modernisation Directive</td>
<td>515 million +</td>
</tr>
<tr>
<td>Capital Requirements Directive/Basel II</td>
<td>2.5 – 7 billion</td>
</tr>
<tr>
<td>Consumer Credit Directive</td>
<td>2.1 billion</td>
</tr>
<tr>
<td>Distance Marketing Directive</td>
<td>Included in IMD costing (below)</td>
</tr>
<tr>
<td>Directive on Portability of Supplementary Pensions</td>
<td>300 million</td>
</tr>
<tr>
<td>Fair Value Accounting Directive</td>
<td>230 million</td>
</tr>
<tr>
<td>Insurance Mediation Directive (IMD)</td>
<td>2 billion</td>
</tr>
<tr>
<td>International Accounting Standards Regulation/IAS 39</td>
<td>500 million</td>
</tr>
<tr>
<td>IORPs Directive</td>
<td>30 million</td>
</tr>
<tr>
<td>Market Abuse Directive</td>
<td>50 million</td>
</tr>
<tr>
<td>MiFID</td>
<td>1.2 - 6.5 billion</td>
</tr>
<tr>
<td>Mortgage credit (possible directive)</td>
<td>Unknown (possibly significant)</td>
</tr>
<tr>
<td>Payment Services Directive</td>
<td>2 billion</td>
</tr>
<tr>
<td>Post-Trade Financial Services</td>
<td>Unknown (possibly significant)</td>
</tr>
<tr>
<td>Prospectus Directive</td>
<td>50 million</td>
</tr>
<tr>
<td>Reinsurance Directive</td>
<td>Minimal</td>
</tr>
<tr>
<td>Savings Tax Directive</td>
<td>50 million</td>
</tr>
<tr>
<td>Second Money Laundering Directive</td>
<td>930 million</td>
</tr>
<tr>
<td>Third Money Laundering Directive</td>
<td>260 million</td>
</tr>
<tr>
<td>Transparency Directive</td>
<td>1 million</td>
</tr>
<tr>
<td>UCITS III Directives</td>
<td>40 million</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>£13.7 - £23.5 billion</strong></td>
</tr>
</tbody>
</table>

Overarching problems with the FSAP

Too much of the FSAP is poorly drafted and overly complex, reflecting the way it was rushed through the legislative process. Only one of the measures Open Europe looked at was subjected to a proper European Impact Assessment and even this lacked proper cost-benefit analysis. Protectionist interests have managed to leave their mark on the FSAP, fatally undermining potentially useful liberalising initiatives. The Markets in Financial Instruments Directive (MiFID) is perhaps the worst example.

A lack of global perspective

London is far and away Europe’s most important financial centre. The cost advantages of conducting business in this European hub are a vital asset to the wider EU economy. The City is globally competitive… indeed it now has a chance of overtaking its US rival. The costs and associated burdens of the FASP will undermine the City's global competitiveness, and therefore that of the entire EU.

Wholesale finance is the City’s major strength, but this is an increasingly competitive global market. London will face heightened competition in the future from Asian centres including Hong Kong, Mumbai, Dubai and Shanghai, not to mention the still formidable strength of New York. The FSAP concentrates too much on Europe as a self-contained market. The FSAP initiatives represent a massive jump in complexity, prescriptiveness and compliance costs for the industry. Too much emphasis has been placed on creating an “averaged out” standard of harmonised EU-wide regulation, politically acceptable to the majority of member states.

This damages mature, wholesale-focused markets such as those that have developed in London, with the threat that professional financial activity will be tied down with “consumer protection” provisions.

Increasing concern among businesses

Rising euroscepticism in the City was also a striking trend – all the more surprising given that London-based businesses and trade associations played an active role in initiating the FASP. As shown by a recent survey by the CSFI, the level of regulation is now the major concern for London’s financial services industry and is clearly reducing the attractiveness of the City as a place to do business. A recent ICM poll of 1,000 UK Chief Executives found that 54% said the costs of extra EU regulations outweighed the benefits of the Single Market they are supposed to create.

Could some types of businesses relocate elsewhere?

The City will remain a major financial centre for the foreseeable future; however, the growing burden of EU derived legislation is likely to encourage smaller, more mobile businesses (such as hedge funds and private equity groups) to relocate offshore. Relocation is a consideration even for more traditional business lines – such as Hiscox insurers who
have moved operations to Bermuda. The banking giant HSBC said they may need to take similar action (in 2004 HSBC estimated it spent US$400 million on regulatory compliance worldwide).

**Attempts at harmonisation undermine competition**
Harmonisation undermines potential competition between regulatory regimes, and hinders the possibility of better regulation initiatives at national level. On the other hand, the degree of complexity and poor drafting that characterises much of the FSAP regulation will make consistent implementation and enforcement of the programme highly unlikely. The historic diversity all too apparent between different national markets, combined with language differences and approaches to regulation, will exacerbate this problem… (raising) the prospect of regulatory arbitrage within (and undermining) the prospect of a common approach across the continent. This is not only bad in itself, but could also provide impetus for the creation of a single European “super-regulator”, an idea that has little or no support in the City.

**How can the FSAP be reformed?**
The approach of current EU Internal Market Commissioner Charlie McCreevy has been generally welcomed by the financial services industry. McCreevy has pledged to halt the tide of regulation. He has thrown down the gauntlet to critics, pledging to reform or repeal legislation that is found to be producing no net benefit, as part of a review of the FSAP in 2007/08. It will be an immense political challenge to substantially overhaul the FSAP legislation already implemented. Nonetheless, it is necessary, and should not be seen as impossible. If meaningful reform is not realised and the burden of regulation affecting the City continues to increase, it is likely that, in the long term, calls will grow louder for the UK to derogate from this area of policy. In order for the FSAP to realise its potential, it must focus on simple principles, as opposed to a complex, rigid drive for harmonization.

The UK should push for the repeal of, or if necessary negotiate opt-outs from, legislation that is particularly harmful or costly - for example the Insurance Mediation, the Distance Marketing and the Market Abuse Directives.

The Transparency and Prospectus Directives in their current forms impose unjustifiable costs upon security issuers. These need to be radically simplified and clarified. MiFID should ideally revert to the first draft of the Second Investment Services Directive. In terms of damage limitation, MiFID should be kept well clear of bond markets, whilst the FSA’s proposals for “price benchmarking” as a solution to “best execution” requirements should be rejected.

**Reform of the process and approach**
In reforming the FSAP, the Commission's priority must be to tackle barriers to entry maintained by individual member states, not least through promoting cross-border “passporting” of financial services. This is preferable to complex, prescriptive drives to enforce harmonisation. Fighting protectionism is likely to prove politically tricky, but it is a priority identified by many of those we consulted.

Passporting of services hinges on minimum standards. The EU can play a role in trying to encourage the adoption of minimum standards through a principles-based European code of conduct. This will promote mutual recognition of regulatory regimes, and allow passporting to work. Greater powers to scrutinise EU legislation at Westminster are needed. Currently, very few MPs are well-versed in the details of the EU's FSAP. MPs must be given a bigger role in scrutinising proposals for legislation and analysing their potential impact. Specifically, the EU Scrutiny Committee in the Commons should be empowered to mandate ministers going into EU meetings to negotiate FSAP directives.

**How to reform the next phase of the FSAP**
Certain measures yet to be passed, such as the Consumer Credit Directive, should be blocked or drastically amended. The Pensions Portability Directive is at an early stage, and should not constitute anything more than a principles-based initiative. The “Solvency II” Directive will be of vast importance to the insurance industry – it must be ensured that this does not become an initiative that tends towards “maximum harmonisation” or protectionism.

Possible future measures – such as proposals to introduce EU regulation over mortgage credit – should be treated with great caution. Pan-European harmonisation would be particularly misguided in this area. Statutory intervention on clearing and settlement of securities should also be avoided.

The largely unregulated hedge fund and private equity industries are attracting increasing controversy. The EU should not pass prescriptive regulation at this stage, but rather adopt a principles-based code of conduct aiming to promote responsible business practices, whilst allowing firms to capitalise on London's advantages in terms of cost and reputation.
APPENDIX 2

Principles-based regulation
By Howard Davies
Financial World February 2007

The choice is straightforward and stark. One may choose to be governed by a set of principles, flexible enough to allow business to develop and evolve. Or, one may opt for a detailed book of rules that governs every element of an individual’s business life in exhaustive, nay exhausting, detail. Which is it to be?

It may seem surprising how many financial market participants choose option two – or at least implicitly do so. The Financial Services Authority (FSA) began to consult on its new handbook in 1999. Once the broad lines of the new legislation were clear, we tried hard at the FSA to simplify the obligations on firms and to cut back on the detail of the rulebooks we inherited from the legacy regulators – the SFA, PIA, IMRO etc, which had all been breeding rules. We adopted the principles enunciated by the former Securities and Investments Board, which deserves the credit for the idea, and adapted them for use across the broader landscape overseen by the FSA. Those eight principles (we managed with two fewer than Moses) could, we thought, in principle substitute for an encyclopedia of rubrics and bylaws. They captured well, in relatively few words, the kind of behaviour a regulator might expect from his flock. Principle one, for example, states: “A firm must conduct its business with integrity.”

Achieving this happy outcome was more difficult than expected. With depressing frequency, the consultation process had the effect of bulking up the rulebook we had begun by pruning. Simple proposed rules, on handling client money, or whatever, were returned with a raft of questions from law firms, demanding greater specificity in the interest of protecting clients from inadvertent regulatory breaches. City trade associations, whose chairs regularly made speeches in favour of radical simplification, subcontracted their responses to consultation papers to firms of lawyers which expensively argued the contrary case. The result was a handbook longer than I or anyone at the FSA intended. My successors have made valiant efforts to shorten it, with some success.

The moral of this tale is that we should be cautious in contrasting the delightful simplicity of the British principles-based regime with the supposedly impenetrable complexity of US regulation. Our system is indeed more principles-based and is certainly less detailed, but we are talking shades of grey, rather than black and white. The Committee on Capital Markets Regulation was undoubtedly right to argue that the US regime would benefit from simplification. We can only be flattered by the positive things it said about UK regulation and the FSA but principles are not an alternative to the hard graft of ensuring that regulations remain relevant.

The Evolving Structure of Financial Regulatory Authorities
By C.A.E. Goodhart
Financial Markets Group
London School of Economics

The Search for Global Singularity in a Complex Multi-national World
In many countries, including the UK and US, a variety of politico-economic factors led to the financial system being compartmentalised in the decades immediately following World War II. Each of the main types of intermediaries, (e.g. retail banks, mortgage banks, investment banks, insurance companies, brokers/dealers, investment funds, etc.), was constrained to operate primarily, if not solely, in their own limited field of business. Regulation, such as it was, was similarly divided along such business lines, often with separate regulatory bodies for each main business line.

Liberalisation, from the 1960s onwards, broke down such separate business divisions and led to the rise of universal banks, or large and complex financial intermediaries (LCFIs) in a much wider range of countries than before. The change in market structure led to pressures for an accompanying change in the organisation of financial regulation. Whereas, formerly, each financial intermediary would usually have had a single designated regulator to oversee its compartmentalised operations, now a universal bank might expect to have a multiplicity of separate regulators within each country in which it operated.
It was the administrative, and organisational, efficiency of moving from a fragmented band of separate small regulatory bodies to a single, integrated, universal regulator that provided much of the driving force for the setting up of integrated regulators. The UK saw the establishment of the Financial Services Authority in 1997 and many other countries have followed the same route.

Differences do, of course, remain between the operational practices and risks relating to insurance, or retail or wholesale banking, or fund management even within a universal bank. So an integrated, universal national regulator will continue to have separate parts (divisions/departments), which will want access to the LCFI. But one of the proudest achievements of the FSA was to establish a single point of contact, or gate-keeper, for each financial intermediary. When one part of the FSA wanted to contact an LCFI, it had to do so via the gate-keeper, who would be privy to all connections and discussions between the LCFI and the FSA. That way such connections could be managed and the LCFI knew whom to contact, e.g. to complain about any excessive regulatory burden.

Much the same dynamic has led multi-national banks to propose operating with a single lead regulator in all, or as many as possible, of their cross-border activities. Whether cross-border financial intermediation is undertaken via branches, subsidiaries, or some other structure, it is usually efficient for multi-national banks to centralise many functions, such as treasury and risk-modelling, although not necessarily all in the same single location. Dealing with one (or multiple) regulator(s) in each country is a pain in the neck for any multi-national bank. It is, therefore, no surprise that the large banks are pressing to concentrate all regulatory responsibility in a single lead regulator, preferably the regulator in the intermediary’s home (headquarter) country. Witness the recent statement of the European Financial Roundtable.

By virtue of the same trend towards multi-national, globalised financial systems, individual countries are increasingly finding significant, systemic parts of their own financial system coming under foreign ownership. Moreover, the centralisation of some functions tends to mean that the host country could not, on its own, resuscitate the systemic (for itself) part of a multi-national financial intermediary, if problems elsewhere caused closure. So, unwilling to cede total dependence for financial stability to outsiders, certain countries with an unusually high penetration of foreign-owned financial intermediaries are moving in the opposite direction to that desired by the multinational banks. New Zealand and Poland are two examples. In such countries, the host authorities would want their local subsidiaries to retain the capacity to continue in operation, independently of the condition of the main part of the bank. This requires a considerable degree of duplication and runs contrary to the multi-nationals’ preference for ‘efficient’ centralisation. On the other hand, is a sovereign nation state really ready to leave its systemic wellbeing entirely in the hands of the residents (supervisors/regulators) of other countries, who may know little (and care less) about the host country?

This home/host tension is likely to remain at the heart of international regulatory discussion for the foreseeable future. The desire by the multi-national financial intermediaries for regulatory efficiency and simplicity will confront the national desire for self-determination. Of course, the more that the latter nationalism is consciously abandoned within a supra-national grouping such as the EU, the less the tension. However, as Dirk Schoenmaker and I have argued, crisis management can be fiscally expensive, so it would require some greater shift of fiscal competences to the federal EU budget to resolve this tension within the EU. There is no sign of any political willingness to move in this direction, at least as yet.

**Two Peaks or a Single Regulator?**

It is, with the benefit of hindsight, clear that the change of market structures within the financial system made the prior business-line structure of the supervisory/regulatory system obsolete. But that does not mean that a single, unified, integrated FSA was the sole feasible alternative. Indeed, much of the intellectual running in the period up to the date of the formation of the FSA was made by proponents of what was been termed the Twin Peaks approach. One of the shortcomings of the remarkably hasty introduction of the new FSA, in May 1997, was that there was no public discussion of the pros and cons of such a structure, as compared with alternatives, such as the Twin Peaks.

Under the Twin Peaks approach, supervision is divided not by the business line or function of the intermediary but by the purpose of the supervision. There are two main reasons advanced for the regulation of financial intermediaries. The first is consumer protection, or conduct of business, owing to the fact that financial intermediation is often complicated and the client at a disadvantage vis-à-vis the institution (asymmetric information). The second is that the failure, and closure, of a financial intermediary can have much greater adverse effects than the closure of most other types of firm. This leads to a need for prudential regulation, both at the micro and macro level.
So it can be argued that it would give more focus to the separate objectives of regulation if these were carried out by separate bodies. The professional requirements of conduct of business regulators, largely lawyers and accountants, differ from those of prudential regulators, largely economists, as does the ethos and culture. (This will have been obscured in the early years of the FSA by the wholesale translation of the Bank of England Banking Supervisory Division to the FSA.)

With the bulk of the day-to-day work in unified supervisory authorities usually relating to conduct of business, there is some fear that a unified regulator will come to be dominated by the legalistic culture that this tends to engender. For such reasons, the case for a ‘Twin Peak approach’ continues to be advanced, despite the opposition of the banks and LCFIs, and the trend to a unified regulator. Only Australia, following the Wallis Committee report, and The Netherlands have bucked this trend, preferring to relate structure more closely to objective.

A unified regulatory body not only bundles together the objectives of policy (conduct of business and prudential), it also commingles legislative, executive and judiciary functions. In other arenas, laws are often set out, intentionally, in general terms by legislative bodies and subsequently interpreted in detail by the judiciary, especially in common law countries where individual cases establish precedents. The bundling together of legislative, executive and judiciary powers in a unified single financial intermediary leads to pressures from the regulated to seek details of safe harbours from the regulator, and causes the regulator, qua legislator, to elaborate regulatory details excessively.

The Lamfalussy process, with its four separate levels, is an attempt to deal with this problem at the European level. Whether there should be some similar separation of function within each nation remains a question, though not one that is often asked. Is the division of responsibilities between Parliament and the FSA sufficient, or should the judiciary function, in particular, be separated more clearly from the other functions? Moreover, this bundling of functions causes the FSA to be perceived as acting on occasions as prosecutor, judge and jury, in contradiction to what appears to be natural justice. This may have the effect of increasing the number of appeals.

A democracy has a representative legislature. Although the FSA does have secondary legislative functions, it is hardly representative, and the ordinary Briton might feel somewhat abashed at the thought of writing to complain about inappropriate conduct of business to the FSA at 25, The North Colonnade, as opposed to writing to his MP at the House of Commons. So, the so-called unified FSA is not, in reality, unified at all. On the conduct of business side, the work is divided between the FSA and a more user-friendly Ombudsman.

In a sense the division between FSA and Ombudsman in the conduct of business field mirrors the division between executive and legislative (FSA) and judiciary (Ombudsman); or is that an incorrect interpretation? From a rather distant viewpoint, there appears to have been relatively little friction between Ombudsman and FSA. Could there be a possible role for a separate judicial body (an Ombudsman for financial intermediaries?) to mediate and decide cases when the FSA wants to charge financial intermediaries with transgression of regulation? Would such separation enable the legislative function to focus on principles, whereas the judiciary would build up a body of case law?

There remain questions as to whether the bundling together of objectives (prudential and conduct of business) and function (legislative, executive and judicial) was really for the best. The banks and LCFIs mostly support it and a large number of countries have adopted it. But the issues remain complex and it is far from clear that there is, or should be, a consensus on what is the best approach. The subject deserves more discussion than it usually receives.

What should be the role of the Central Bank?
Until the fashion began, in the 1990s, for moving to a single integrated regulator, the banking sector had, in most cases, been regulated and supervised by the central bank. Most single, integrated regulators were, however, established at some distance from (though with linkages to) the central bank. This trend occurred at about the same time as the move towards granting operational independence, often for inflation targeting, to central banks. There were several good reasons for this simultaneity, including:

(a) Reputation contagion. Almost all regulators/supervisors agree that some banks/financial intermediaries should be allowed to fail; and some will do so. When this happens, however, the regulator/supervisor will be criticised. An inflation-targeting independent central bank needs credibility in order to anchor expectations. Being yoked to a banking supervisory body could endanger such credibility.

(b) Extended safety net. Banking supervision by the central bank went hand-in-hand with some safety net for the banks. The blurring of business dividing lines meant that supervision would tend to encompass LCFIs, incorporating...
security market and insurance activities. If the central bank was to cover the whole gamut of supervisory oversight, would the safety net be presumed to be extended to a wider range of intermediaries and markets?

(c) Excessive power and democratic deficit. Operational independence granted significant extra power to the central bank. Would it be appropriate for an unelected body not only to have such powers, but also to undertake regulatory/supervisory management of the whole financial sector? By the same token national central banks within the eurozone, having lost their monetary policy role to the ECB, are most vehement on the need to retain their supervisory functions.

(d) Focus, or conflicts of interest. Central banks with operational independence will want to concentrate on their primary responsibility for achieving price stability. While the claim that there could be conflicts of interest between the objectives of price stability and financial stability are frequently exaggerated, they can occur.

(e) Globalisation and the arrival of foreign banks. This has meant that central banks have diminished power to resolve domestic financial crises on their own, for example by leaning on domestic banks to help bail out their weaker brethren. Increasingly, central banks have had to turn for assistance to ministers of finance.

This list explains why the single, integrated regulator has come to be located at a distance from the central bank in developed countries. But conditions are different in emerging economies. Not only is the structure of financial intermediation generally simpler in such countries, but also the required characteristics of a financial supervisor, notably independence, professional expertise and adequate resources, which may be taken for granted in a developed (large) economy*, may not be easily available; they may be better obtained within a central bank than outside it.

But even if responsibility for financial supervision is removed from a central bank, it is bound to continue to have concerns in this field, relating to:

- the smooth working of the payments system and, by extension, of the settlement and payments system of the main financial markets;
- the operation of the money market and the foreign exchange market, and by extension of the other main financial markets;
- the provision and management of liquidity, if necessary including Lender of Last Resort functions.


This acceptance of some diminution of the Bank of England’s role was sensible. It was never clear what responsibility for systemic stability could really mean in a context where supervision was entirely done elsewhere, and where crisis management would be undertaken by a tripartite committee (FSA, Bank, Treasury). So, unlike the question of the optimal internal structure of the regulatory authority, or authorities, where many questions remain, the divorce of integrated supervision from the primary operational functions of a central bank has become more generally accepted, at least in large developed countries with operational independence and monetary policy responsibilities.

*In a recent paper (Mishkin and Herbertsson, 2006) on Financial Stability in Iceland, one suggested reform was to return the FSA there within the central bank, on the grounds that there were so few experts in the field in the small Icelandic economy that concentration would be better.
culture. The main difficulty arises from the wholly different regulatory imperatives of the retail sector and the wholesale markets. Customer protection is the main objective of regulation of financial services and products in the UK as these impact on the investing public, a mission made more difficult by the low level of knowledge and understanding by the public of the risk/reward ratio attached to even the most standard of financial products. The regulatory imperative is focused on the products and their distribution, with emphasis on disclosure standards and suitability. Promulgation and enforcement of rules is necessarily copious and prescriptive, and involves intensive compliance scrutiny and assessments of relative regulatory risk. Prudential supervision is integral to the mandate, but it is essentially focused on assuring that product producers are able to satisfy the financial commitment inherent in the product rather than with reference to engagements with professional counterparty.

The regulatory imperative with respect to wholesale markets is systemic risk. Therefore, the focus is on capital adequacy and the integrity of markets. The promulgation of rules and the enforcement of best practice to ensure fair markets are determined in the context of dealings between knowledgeable professionals. Institutional supervision is with reference to the risk inherent in the authorised institution's business mix and the capital requirement to support each activity, not specifically the products manufactured, that is, the risk associated with principal dealings not agency functions.

The skill and experience base required to discharge the essentially different missions described above is itself essentially different and requires different styles of management and approach to the execution of the respective mandates. The danger in combining these activities in one monolithic institution is that none is executed with maximum efficiency and regard for the competitive needs of the sectors being regulated. The impact on the innovative dynamic in both sectors can be particularly severe, leading to a loss of international competitive advantage.

The evolution of retail market regulation is towards the Continental prescriptive model. The FSAP seeks to achieve a single market in financial services in the EU. This requires a dismantling of the protectionist measures at member state level previously justified on investor protection grounds. The political trade-off for this dilution of sovereignty is a harmonisation of investor protection regulation. This is an acceptable trade-off to the large institutional base increasingly dominating the manufacture and distribution of retail savings and investment products. They gain a larger market in exchange for some increase in compliance costs, mitigated in competitive terms by the increased cost of entry to the market this implies for smaller operators who cannot afford these increased costs. But the Continental model that will emerge is based on Napoleonic code legal principles, “You can only do it if it says you can”, summarises this approach, whereas the Anglo-American, common law approach implies “You can do it unless it says you can’t”. There is a world of difference between these two concepts when translated into a regulatory model.

Whereas this may be acceptable to the retail sector because of the protection it implies for existing market shares, its consequences for the City can be dire. However clever the UK’s implementation of FSAP Directives might be (witness the brouhaha over MIFID), in the end the FSA will not be able to resist the imposition of the Continental model. It follows that the only way to protect the wholesale markets (the City) from this contamination is to rethink the architecture of the UK regulatory model and to effectively, if not on a statutory basis, seek an exemption, or carve out, from the EU regulatory model as it impacts on the retail market, so as to protect the wholesale market’s international competitive advantage. Of course, if properly presented, such an aim will be seen as being to the benefit of the EU as a whole, since the purely national UK interest in the City, as far as ownership is concerned, is now minimal.

The transfer of banking supervision from the Bank of England to the FSA coincided with the decision to grant the Bank independence over the determination of interest rates (although appointments to the Bank’s committee of economists are still Treasury determined). Observers at the time linked these two measures, although there is no evidence that the Chancellor’s thinking was: “give away with one hand and take back with the other”. In the final analysis, both the Bank and the FSA are under political control. There seemed to be logic in bundling all financial regulation under one statutory body. The previous SIB/SRO regime was perceived to be too self-regulatory in nature. But this was flawed thinking; the result is a mix of prescriptive and principles-based regulation which suits neither sector ideally. It creates bureaucratic sclerosis, enforcement confusion and a decline in standards of best practice, increases costs that are ultimately passed on to consumers, and risks damaging the City’s competitive advantage.

The argument that practitioners benefit from a single regulator is spurious. The leading practitioners are international financial conglomerates who have a compliance responsibility to a host of regulators. For its US business alone, a firm like Merrill Lynch is regulated by the SEC, the NASD, a dozen securities and derivatives exchanges, the Comptroller of the Currency, the NY Federal Reserve Bank and a number of other agencies including the Inter-State Commerce Commission and authorities in all the states in which it transacts business. It also complies with regulators in all the overseas jurisdictions in which it is represented. If the present FSA rule book was replaced by two rule books, the
combined number of pages of which was half the present single rule book, there would be an automatic compliance cost saving. All firms’ compliance departments are organised on business lines, in any case.

Why not transfer back to the Bank of England regulatory and supervision responsibility for the wholesale sector? By the wholesale sector, we would mean: commercial banking, investment banking (i.e. principal trading in securities and derivatives), advisory functions and all activities involving dealings with professional counterparties, exchange-related functions and so on. The test would be the counterparty definition. The Bank already has, and retained after the transfer of its supervision and authorisation of banks, ultimate responsibility for systemic risk monitoring in its capacity as custodian of the currency and the National Debt. It is, therefore, geared to a solvency-based regulatory function.

More importantly, sanction by the Bank in the case of infractions carries much more weight. Best practice in the City has deteriorated because of an absence of “social stigma” attached to enforcement action by the FSA – a faceless bureaucracy. Fines are regarded as a cost of doing business and, in any case, are usually levied long after the infraction has been forgotten. A slap on the wrist from the Bank, applied with urgency, was always worth as a deterrent any number of formal enforcement actions.

Costs would be reduced, despite claims of administrative synergies in a single agency, because productivity would be substantially higher. Flexibility and the ability to adapt regulatory and supervisory action to new market developments would be hugely enhanced. More importantly, the ability of the Bank to protect both the integrity of the UK’s wholesale market and its competitive advantage would be self-evident, given its prestige, its international standing and its experience. The FSA would benefit through its development of a corporate culture entirely driven by customer protection issues across the range of consumer products it is now responsible for, including cross referencing and database synergies. And it would dispose of additional resources to concentrate on a consumer education mandate. Its financing could be assured entirely by small product related taxes which, if properly structured, would more than compensate for current wholesale market subventions and fines.

The UK wholesale market runs the risk of being squeezed between increasingly prescriptive EU-driven regulation and US extra-territoriality in regulatory matters. It needs a dedicated and prestigious protector. Only the Bank fits the bill.

**Risk Ladder for Investment Products**

By Peter Wilson-Smith

Unless a retail investor understands the basic risk characteristics of the main types of financial asset, and how they relate to each other, it is very hard to make sensible decisions about savings. A system of risk rating of savings and investment products to show the relative position they occupy on a Risk Ladder would be an important aid to investors. It would give them an idea of the relative riskiness (defined as the likelihood of change in nominal value) of the different types of financial asset they are likely to come across.

It is important to understand that the Risk Ladder proposal is designed to help investors identify the relative, not the absolute, level of risk inherent in different types of product. There are many different types of risk affecting investment products – inflation risk and diversification, for instance. But the purpose of the Risk Ladder idea is not to explain portfolio theory or every important aspect of investment to the person on the street. The aim is to give people who have little understanding of financial products some clear benchmarks.

He are starting from a position where the level of financial literacy in the population is extremely low. According to Mick McAteer, formerly of Which?, half the people don't know what 50% is. Even among those who do understand percentages, many find it hard to grasp essential and fundamental financial concepts such as the fact that when interest rates go up, the price of a bond goes down. Nor do they always understand the different properties of a deposit account, government bond, ordinary share or mutual fund invested in a spread of different shares.

**How the system would work**

The risk ratings would cover broad categories or types of investment product to show the spectrum of risk from low to high. It would exclude car or general insurance, which is not an investment product, and it would not take account of tax structures such as ISAs, PEPs and SIPP s.
The categories on the Risk Ladder could include:

- Deposit/savings accounts
- Money funds
- Government bonds
- Corporate bonds
- High yield bonds
- Equity mutual funds/investment trusts
- With profits insurance policies
- Individual shares
- Options/derivatives etc

Each category could have a short description of its main characteristics, explaining the risk involved in relation to certainty of capital and income. (This could mention the impact of inflation risk where appropriate.) In the case of equity mutual funds, it would need to make the point about diversification/not putting all your eggs in one basket, but also point out that mutual funds can still fluctuate considerably in value. Each description could also comment briefly on the likely trade-off between risk and return.

Once agreed, the Risk Ladder could become widely used and retail financial services companies could badge the financial products they sell with a risk category corresponding to one of the categories on the ladder. The purpose of the Risk Ladder would not be to indicate whether a product was "suitable" for a particular individual, because that depends on an individual's circumstances. The purpose is to help consumers to understand the relative risk of a particular product.

Implementing the Risk Ladder concept
Risk ratings could complement the simple product descriptions proposed in the Working Group's report. The mechanism for implementing the system could involve the industry working with the sector standards setters to agree the broad categories on the Risk Ladder. Financial services providers would then be expected to identify the risk category into which their products fell. Compliance would be voluntary but there would be clear benefits for the industry, which would make it likely that practitioners would adhere to the system.

Conclusion
At the end of the day, this is a simple idea - a Risk Ladder of types of investment products with a short description of the risks and characteristics of each category. Financial products could then be badged according to the category in which they fitted. Of course, this will not in itself enable savers and investors to make optimal decisions about how much risk they should assume when saving for their pension or what they should do in a high inflation environment. But it would help them to make a better informed judgment than many are able to at present.

Risk Ratings
By Charles Goodhart

The concept of providing simple, clear risk ratings for financial products [see above, Peter Wilson-Smith] is seductive, the more so the less financially aware the savers may be. But in my opinion it is misguided. There are just too many dimensions to risk to provide such simple categories.

The most basic dimension of risk is the likelihood of a change in the nominal value of an asset over the next few months. But this ignores several other key factors. First, what a saver wants is command over future real resources. If rapid inflation is possible/probable, then holding an asset with a fixed nominal value such as cash, or bank deposits, can be very risky in real terms. Second, the saver may not need the funds for many years. If you hold an asset whose maturity (duration) matches your holding period, then you are in a safer position than holding a series of short-dated assets, although in the interim the price volatility of the longer-dated asset is much greater. Third, the riskiness of an asset does not depend just on its own characteristics but on the effect of adding it to the overall portfolio. Consider an asset which pays out £10,000 if it rains at Heathrow on 1 June 2007 and zero if it does not. Very risky? But what if you can buy a second asset which pays out zero if it rains at Heathrow on 1 June 2007 and £10,000 if it does not? If you combine the two in a portfolio you get £10,000 for sure on 1 June. Or do you? How about credit risk that the company that
sold you the asset that should pay out £10,000 goes bust in the meantime? Is it sensible to try to give a risk rating on a product without also considering the status and rating of the company issuing the product? But the latter has some considerable inherent problems.

I could continue to describe the multi-faceted nature of risk. One reason why people are unsure about risk is that it is such a complex issue. As a result, they are likely to be exceedingly swayed by simplistic rankings. Particularly with the switch from defined benefits to defined contributions in pension plans, more savers will have to decide how to invest their own pension pots. There could be a serious danger that they could be persuaded to adopt, as a default option, holdings primarily consisting of short-term money market type assets, since these have little risk of changes in nominal value. For those with longer term horizons, what they really need instead, as their safest option, is a time-varying combination of indexed bonds and a diversified holding of equities, via a mutual fund for instance.

In short, the risk of a financial product cannot be assessed in isolation. It depends on the particular context, needs and portfolio position of the saver.

---

**Consumer perspective**

By Mick McAteer

Policymakers in the UK face a number of critical public policy challenges over the coming decades – how to ensure citizens have a decent retirement; protecting citizens against risk in what is perceived to be a more uncertain, unpredictable world; making sure people have the assets, and therefore the opportunities, to participate fairly in society; and providing access to decent health and social care. A successful UK financial services industry is central to those challenges – to provide the pensions, savings, investments, insurance, credit and banking services consumers need.

If the industry is to serve consumer, not just shareholder, interests, then markets need to be: fair and efficient; inclusive; secure and stable; operate to principles of democratic capitalism; and above all have the confidence of consumers. It goes without saying that an effective regulatory system can contribute to those aims. But equally, if done badly, regulation can distort markets, hinder competition, create barriers to inclusion, undermine stability and confidence, create conflicts of interest in the distribution chain and entrench vested interests.

So, consumer representatives, the market and policymakers have an interest in getting regulation right. The difficulty lies in getting the balance right within an appropriate public policy framework. The FSA was right to move to principles-based regulation, away from prescriptive rules-based regulation. Core rules on issues such as information disclosure, authorisation, training and competence and so on will always be needed, but unnecessary rules can introduce additional costs which benefit neither industry nor consumer. Good regulation should focus on the root causes of detriment such as conflicts of interest in the distribution chain - and promote real competition in markets.

But the move towards principles-based regulation (particularly the treating customers fairly initiative) has clearly not been easy for many market practitioners who have struggled to embed the concept of ‘principles’ into business processes – many miss the comfort blanket provided by rules. The proposals in the CSFI report represent the best attempt so far at creating a model which allows principles-based regulation to work in practice.

The FSA hasn’t yet demonstrated that principles-based regulation will work for consumers. But if it can reassure consumer representatives that it is determined to make TCF work by addressing conflicts of interest such as commission biased sales, and by acting as a robust enforcer of TCF, then consumer and industry representatives and regulators have the opportunity to work together to streamline regulation and remove rules which serve no real benefit.

I would propose that the rule book should be assessed using some very simple criteria:

- has the regulation/rule prevented, or is it likely to prevent, detriment occurring?
- does the regulation/rule act as a proxy for competition, ie. does the rule require firms to adopt good business practices that would be normal if competition was working?
- is the regulation/rule proportionate?
- is the objective of the regulation/rule covered elsewhere by another regulation/rule?
This approach could reduce the size of the rule book by removing much of the dead wood. This should lower the costs associated with regulation as well. However, the one area where I dissent from the views of the rest of the working group is the extent to which ‘excessive’ regulation is adding to business costs. The cost savings may not be as great as imagined.

The key question is whether regulation introduces unreasonable cost requirements (through additional processes or staff training) over and above those that firms would normally incur if they were acting professionally and treating customers fairly, i.e. ‘incremental costs’. It is reasonable to assume that a well-run firm will: ensure that staff are trained and competent to do their jobs properly; know what a customer’s financial circumstances are and his or her preferences and attitudes to risk when offering advice and products; produce information that is fair and accurate; treat complaints fairly and hold itself up when things go wrong. The Deloitte study for the FSA found that while regulatory costs are higher in the retail sector, one of the main conclusions was that “much of what regulation requires is, in fact, regarded by firms as good business practice”. Regulation is a trade-off for retail financial services firms. The real incremental costs of regulation are very low in comparison to the acquisition, distribution and marketing costs of doing business.

But, to use an awful piece of management speak, regulation should be primarily about successful ‘outcomes’ rather than processes and if the same outcomes can be achieved with fewer prescribed and detailed rules then so much the better. And, again I would reiterate the view that the CSFI proposals provide a model for allowing principles-based regulation to work in practice without undermining consumer protection.
APPENDIX 3

Principles-based regulation – what does it mean for the industry?
Speech by Sir Callum McCarthy, Chairman, FSA
Financial Services Skills Council Second Annual Conference
31 October 2006

There is no prospect of the FSA moving to a regime based exclusively on principles. We will always have a mixture of specific rules and general principles. The policy question is the balance between the two, and in particular the extent we can rebalance between the present very large (8,500 pages and growing) rule book on the one hand and principles on the other (the FSA’s eleven core principles can be fitted onto a 5” by 3 ¼” card. It contains 194 words). This rebalancing will not be easy. There is a constant flow of new rules from the EU…; firms and their trade associations…often in practice show a surprising attachment to any rule which it is proposed to abolish; and within firms there is very often a contrast between the expressed wish of chairmen and chief executives to embrace principles and the concerns of their lawyers and compliance officers who prefer the certainty provided by rules. So the rebalancing will not be easy. Although it will not be easy, we are determined to achieve it.

My second point…is that a move to more principles-based regulation has implications not only for the firms, but also for both consumers and the FSA. Sometimes our determination to move to the rebalancing we seek is discussed as if its principal objective is to lighten the regulatory costs borne by firms. This, although clearly one benefit, is not the principal objective. We are making the rebalancing between principles and rules because we believe this will enable the FSA better to discharge the duties Parliament has given us…And, just as the objective we are seeking in our rebalancing is wide, so are the implications of this rebalancing, in that it will affect firms, consumers and the FSA – in some ways quite profoundly.

…Let me now turn to the changes I expect to see, starting with the impact on firms. The first impact of a move towards more principles-based regulation will be a continuing and intensified reliance on the senior management of the firms we regulate. We will expect them to think hard about the principles we are attempting to promote, in terms not of mechanisms which have to be adopted but rather in terms of the outcomes which we are seeking. The FSA’s work on treating customers fairly is a microcosm of what more principles-based regulation will require: not detailed rules setting out limitations on the form of advertising, or the scale and use of commissions, or governing any other particular parameter, but rather a concentration on the outcome of customers who – by means chosen by the senior management of the firm, not mandated by the FSA – have been treated fairly. This places a heavy responsibility on the senior management of a firm: to consider, for every part of its business and for every part of the product life cycle within a particular business, whether its processes actually promote that end – are products designed to meet consumer needs? Is advertising not only true, fair and not misleading but aimed at appropriate audiences? Do sales incentives incentivise appropriate sales, or simply maximise sales? Are complaints properly handled?

Treating customers fairly illustrates what firms should expect from a more principles-based approach: more attention to outcomes, less prescription as to the method of getting to those outcomes; greater responsibility given to senior management and – rephrasing that – greater opportunity given to senior management; more freedom for firms to innovate, since the emphasis will be on outcomes, with flexibility as to how those outcomes are reached.

…I think that the contact between FSA and regulated firms will change, both in terms of the level of contact and the content of that contact. The level will change towards greater contact between FSA and senior management of the firm, reflecting the increased focus on the responsibilities of senior management, away from FSA: specialist compliance function contact. And the content of those discussions will also change, away from investigation of whether evidence exists to demonstrate compliance with specific rules to discussion of broader issues and of desired outcomes: in short, a move away from what is normally characterised as “box ticking” – the comfort zone for both regulator and compliance functions.

The basis for enforcement action will also change, in that there will be more instances of enforcement based on breach of principles, and fewer based on failure to comply with detailed rules. Again, this change will be a matter of degree, not an absolute change.
The FSA already pursues enforcement cases on the basis of breach of principle rather than breach of detailed rules. Some of the largest fines imposed by the FSA have been for breach of principles. The enforcement action against Citigroup…resulted in a fine of £13.9 million, and the recent enforcement action against Deutsche Bank…which resulted in a fine of £6.3 million, were both for breach of principles. So there is nothing new in the concept of more principles-based enforcement action. It would also be entirely compatible with the emphasis more principles-based regulation places on the responsibilities of senior management to find enforcement action is directed not only at the firm but also, where the circumstances of the case justify it, at individual senior managers as well. I have no illusions that successful prosecution of these cases will be easy.

I am also conscious that firms and their senior managers will be concerned that enforcement action based on breach of principle rather than of rule exposes them to dangers: that enforcement action might be based on an interpretation made some time or long after the event which imposes a standard of behaviour which was not current at the time of the event which has triggered the enforcement action. Again, this fear of retrospective imposition of standards is not a new issue. It is a complaint which is raised today both in respect of the FSA’s interpretation of rules and – even more – in respect of the Financial Ombudsman Service. But it is a concern which we need to respect. We need to enable firms to know, at the time when they take an action, whether that action should expose them to the prospect of enforcement action because it is a breach of either principles or rules: in short, we need to establish a condition of predictability. When that condition of predictability has been established, it will be entirely legitimate for a breach of principles to entail consequences, including enforcement action, for the firm or individual committing the breach, even when no specific rule has been broken.

Again, I do not underestimate the difficulties which we can expect to encounter as we move further in this direction. It will require those who advise the senior management…to embrace a new skill set. Rather than advising on specific rules, and the precedents which have been established around those rules, they will be required to take a wider and more judgemental set of decisions as to whether particular practices within a firm are reconcilable with desirable outcomes and general principles. I have no doubt that it will make the responsibilities of compliance departments both more interesting and also more difficult. Equally, I expect that they will make life more demanding for the FSA, in that they will properly want to discuss the application of principles with the FSA, and will raise questions of interpretation which will require an informed and thoughtful response: straight questions deserve straight answers. I hope that both sides will rise to the new challenges, and that the content of the contact between regulator and regulated which I referred to earlier will be substantially more based on real issues rather than on narrower discussion of rules – in enforcement as elsewhere in the regulatory relationship.

The present relationship which the FSA has with the firms we regulate differs markedly according to our assessment of the impact a firm may have on our statutory objective, and of the likelihood of this impact occurring. On this basis, we assign firms to different categories, ranging at one end from the relatively small number of firms of sufficient importance for us to have a close and continuous relationship with them to at the other end the very large number of firms which in the normal course of business we neither plan to visit nor to have over them a traditional supervisory oversight, but instead to rely on thematic studies and general statistical knowledge of the population. Less than one per cent of all the firms we regulate fall in the first category. More than 90 per cent of the 29,000 firms we regulate fall in the second category. For the latter category, the principal communication with the FSA, other than statistical returns, is via the FSA’s contact centre. We recognise that one – of many – necessary conditions for a successful move towards more principles-based regulation is substantial change to the operations and scope of our contact centre. As well as the many detailed questions which are at present answered…there will be more general questions: is a particular commission structure compatible with treating customers fairly? How should promotions be phrased? Although in very many instances the FSA will be able to – indeed should – do no more than expose the implications of a decision which must lie with the firm, there will be a need for a system within the FSA which allows us to give sensible, consistent and timely judgments for small firms who approach the FSA through the contact centre as much as for those large and important firms with which we maintain close and continuous contact. I regard this as a major task for the FSA.

Another area which will be affected by the FSA’s move towards more principles-based regulation is that of training and competence. We have already undertaken to remove detailed training and competence rules…in the wholesale market, which will happen in November 2007, to coincide with the implementation of MiFID. I have no doubt about the correctness of this decision, even though it was a prime example of institutions which in general support the abolition of rules objecting strongly to the application of this to a particular set of issues. But it should be the responsibility of those who manage wholesale firms to employ and train staff competent to do the job; and for them to decide on the appropriate tests, exams and qualifications they find most useful to deliver that outcome. I accept – though I confess to reservations – the concerns which are expressed about applying this principle in the retail market; and I am conscious both that – for better or worse – MiFID imposes a high-level competence standard, and that in future under MiFID...
we cannot impose any of our training and competence standards on firms which are passported into the UK from elsewhere in the EEA. So there is a complex set of arguments, not all pointing in the same direction, which require us to reconsider our training and competence rules. We intend to publish a review of this in February 2007.

…Since 2004, when the FSA stopped prescribing exam requirements in the FSA Handbook – an early move towards principles – we have relied on you to set the exam standards…I think in the future we will see much more of this model: the regulator establishing a principle in terms of a desired outcome – in this case firms who employ staff with the expertise and competence required for them to discharge their duties properly – and other bodies – giving the guidance or setting a specific standard which helps individual firms meet that principle.

…I said that the driver for our rebalancing in favour of more principles-based regulation is our conviction that this will enable us to meet our statutory objectives more effectively: that the principle of treating customers fairly, rather than detailed rules, is the most effective way of ensuring a fair deal for the retail customer; or that the principle that firms must manage the conflicts which they have is a more effective way of dealing with conflicts which are both endemic and unavoidable and occur in ever novel forms than would be the Sisyphean task of drawing up rules to cover each specific conflict. That said, there is undoubtedly a regulatory dividend for firms from the FSA’s move to more principles-based regulation. The first element of this…is a reduction in the administrative costs which regulation imposes on firms: the costs firms incur in reporting to the regulator. We estimate…that the total administrative cost of FSA regulation runs at £600 million annually – a very large sum, but about ½ per cent of the associated industry turnover. Changes already made to our regulation, notably the move from 57 to 2 pages of rules covering anti-money laundering, have already removed requirements associated with annual reporting costs of £250 million – roughly a 40 per cent reduction. The FSA has a programme to review other parts of our rules which will result in our having reviewed by the end of 2008 activities which together account for more than 80 per cent of the administrative costs we impose. I am confident that this review will identify other opportunities for us to move further in the direction of principles, as the most effective means of meeting our statutory duties. And I am also confident that, by so doing, we will find further means of lightening the costs borne by firms.

Our review will be serious and thorough. That I can promise. What I cannot promise is to reach any particular target for reduction in administrative costs. There are two fundamental reasons for this, both firmly based on the Act of Parliament which gives the FSA its powers and duties. The first is our overriding duty to meet our statutory objectives, and our concern to do this. It would be quite wrong to commit to a particular reduction in administrative costs if achieving that were to make it impossible to deliver on our statutory duties…I would add that it would also be perverse to concentrate on a target defined exclusively in terms of administrative costs alone. One reason that the FSA is able to run a very light supervisory regime for more than 90 per cent of the firms we regulate is because we have some (relatively simple) reporting requirements on which we rely – and which impose administrative costs. It would be possible – but perverse – to reduce those administrative costs but then have to achieve our statutory objectives at greater expense…by imposing a more intrusive and expensive supervisory regime. As you would expect of any intelligent regulatory organisation, the FSA is much aware of the law of unintended consequences. The second reason is that we are committed to consulting on any changes and consultation means not only receiving, but also considering seriously, the comments and arguments of those who respond to our consultations. This is a process which we cannot pre-empt. So, for both those reasons, I cannot forecast the outcome of our reviews, though I can indicate that we have already reduced administrative costs by 40 per cent; and expect to do more.

…I believe that regulatory dividend of the FSA’s move towards more principles-based regulation will go far beyond administrative costs. The changes to our anti-money laundering regime, for example, will encourage firms to adopt a more risk-based and practical approach, not merely allow them to avoid bureaucratic requirements. And our proposals for a more risk-based approach towards the capital of life companies should result in their being able to reduce their capital requirements by some £4 billion.

Let me conclude. I have attempted to indicate what more principles-based regulation will mean not only for firms, but also for consumers and for the FSA. I have described some effects we expect for senior managers, and for those who advise them, and dwell on some particular issues of compliance, enforcement and regulatory dividend. I will be interested in your responses.
Principles-Based Regulation – focusing on the outcomes that matter
FSA April 2007
http://www.fsa.gov.uk/pubs/other/principles.pdf

Measuring regulatory outcomes
We will need to be guided in our implementation of principles-based regulation by [the] clearly articulated outcomes we want to achieve and against which we can measure and report our performance.

To help us both to embed principles-based regulation and to track our progress in a structured and consistent way, we have now taken an additional step by defining nine outcome indicators … which are set out in the panel below. These explain what success in delivering the three aims will mean in practice and will, over time, enable us to judge our achievement of that success. These indicators will increasingly drive our planning, decision-making and operational activities.

<table>
<thead>
<tr>
<th>Strategic Aim</th>
<th>Indicator number</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Help retail consumers achieve a fair deal</td>
<td>1</td>
<td>Consumers receive and use clear, simple and relevant information from the industry and from us</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>Consumers are capable and confident in exercising responsibility when dealing with the financial services industry</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>Financial services firms treat their customers fairly and so help them to meet their needs</td>
</tr>
<tr>
<td>Promote efficient, orderly and fair markets</td>
<td>4</td>
<td>Firms are financially sound and well managed</td>
</tr>
<tr>
<td></td>
<td>5</td>
<td>Firms and other stakeholders understand their respective responsibilities and mitigate risks relating to financial crime and arising from market conduct</td>
</tr>
<tr>
<td></td>
<td>6</td>
<td>Financial markets are efficient, resilient and internationally attractive</td>
</tr>
<tr>
<td>Improve our business capability and effectiveness</td>
<td>7</td>
<td>The FSA is professional, fair, efficient and easy to do business with</td>
</tr>
<tr>
<td></td>
<td>8</td>
<td>The FSA is effective in identifying and managing risks to our statutory objectives</td>
</tr>
<tr>
<td></td>
<td>9</td>
<td>The costs and benefits of regulation are proportionate</td>
</tr>
</tbody>
</table>

Is the present business model bust?
Speech by Sir Callum McCarthy, Chairman, FSA
Gleneagles Savings & Pensions Industry Leaders’ Summit
16 September 2006

Let me start with a little history, one distant example, one recent. Both relate to incentives. In the 18th century, we exported our criminals to Australia, and paid on the basis of every convict shipped aboard at the quayside at Bristol or London. On average, 12 per cent of those who were shipped aboard in Britain died en route; on some voyages more than one in three of those shipped died before reaching Australia. In 1792, the system was changed…shippers were paid for every convict delivered alive in Australia, rather than shipped aboard in Britain. In 1793, three convict ships sailed to Australia transporting 422 convicts, of whom 421 were delivered alive…The new reward structure produced immediate and dramatic change. My second example…relates to the opening of the retail market for gas and electricity in the UK to competition in the late 1990s….All the energy companies paid their sales forces against signed contracts…with the result that there were numerous abuses: forged signatures, signatures from children, incorrect
claims of the savings from benefits, disputed contracts. Eventually (and with some regulatory encouragement), all the
energy companies changed to paying commission against signed contracts only after they had been subsequently
confirmed by the customer, and abuses essentially stopped – not because door to door salesmen and women had
become more ethical, but because it was not profitable to cheat. My first point is, quite simply, incentives matter. They
change behaviour.

…My contention is that we have a system which serves neither the producer of the services nor the consumer of the
services. It is doubtful whether it serves the intermediary either… The provider of the retail financial service wants over
time to associate his or her brand with qualities of reliability, trustworthiness, performance, and to establish and develop
a long term relationship with customers… If this is the aim, what we have fails miserably:

• The present distribution system is distinguished by a focus on business volume rather than quality. Symptoms
of this are the attention still given to Annual Premium Equivalent (APE) as a measure of business success…. The very
significant volumes of transfers between provider firms in the pensions market, which amount to about half of new
single premium personal pensions… add to the APE numbers, but can give a false impression of how much actual new
revenue is coming into the industry as a significant proportion of so-called ‘new’ business would appear to be regular
premiums and single premiums that have been transferred from other providers. This 'merry go round’ as it has been so
characterised, not only reduces, if not eliminates, the profitability of the business, it also proves a major obstacle to firms
establishing long-term relationships with their customers. Questions also have to be asked as to how much of this
recycled business is of negligible advantage to the customer.

• So, not surprisingly, persistency of policies is low with… around half of customers who buy regular premium
personal pensions no longer paying into them after four years. Given the structure of commission, the fact that around
one in six of those who take out a regular premium personal pension stop contributing to it after one year means that
many may be penalised. Indeed, one has to question whether products that are subject to that level of attrition should
be designed, priced and marketed – and, of course, generate commission – as if they were long term regular premium
products at all.

• These points strongly suggest that while there is clearly a lot of activity in the pensions market, it is not clear
how much is motivated by the customer's best interests. I recognise, of course, that there are entirely legitimate
circumstances in which transactions with limited life will properly occur – for example, change in employer,
dissatisfaction with current investment performance and so on. Others, however, will be conspicuous examples of either
mis-buying, or mis-selling, or some combination of the two. Where this is the case, it has to be recognised that frictional
costs associated with such transactions will inevitably take out value from the system. In turn, this will diminish, and
may eliminate entirely, returns for providers and customers. Arguably, distributors suffer too. The sum picture is one
that is incompatible with developing either a reputation for the industry as a whole, or a brand reputation for
individual companies.

The consumer does no better than the providers under the present remuneration model. This suffers from product
bias, provider bias and churn. Product bias... is arguably the most detrimental. Consumers are not always advised on
transactions which fail to remunerate the adviser, or which offer little by way of commission to the adviser. So, for
instance there is a dearth of advice on paying off debt or the course of action to take with profits policies, and national
savings and investment trusts are neglected. Provider bias is clear: I am struck by the prevalence of examples of
providers managing demand — up or down — by adjusting commissions which can lead to less suitable or even
unsuitable sales. Linked to provider bias is churn, with the potential for significant consumer detriment from paying
unnecessary commissions, charges or fees when induced to switch from one product to another despite the benefits of
such a move — if they exist — only materialising after a long period during which the switch has been to the consumer’s
detriment. So the consumer does badly from the present business model too. Please note that I am not saying that
commission as an incentive is necessarily bad — but at present it is clear that the way in which firms are managed when
the commission model applies frequently fails to mitigate these high risks of inappropriate advisory and transactional
activities taking place.

It is often claimed that the beneficiary of the present model is the intermediary... I think this is a proposition which
needs further probing. The present system, with its in-built encouragement to churn and its product and provider
bias, is not one which is naturally robust to claims for mis-selling, and the associated compensation liabilities. I note that
as at May 2006, the top 21 IFAs had turnover of £640 million, but operating losses of £22 million — twice that of a
year earlier. So I don't think we should assume that the present model is good for even the intermediaries.
So my second point is that we have at present a business model which is based on incentives which produce results which are unattractive to reputable providers, unattractive to their customers, and whose benefits to intermediaries are questionable. What are we going to do to change it?

Of course, some of the responsibility for the evolution of this unhealthy model must lie with the legislative and regulatory policies of the past quarter century. In a moment, I will discuss the regulatory initiatives...designed to make the market work more effectively. But the solution to the problem must lie principally with the industry. And one of the key questions that must be addressed is this: who is the real customer of the provider – is it the policyholder who invests their money in the hope of seeing a decent return? Or is it the distributor, who in the main, secures access to the end-consumer for the provider? If, as many commentators would have it, it is indeed the distributor who is the actual customer of the provider, this raises all manner of difficulties which further perpetuate the shortcomings of the current model – particularly with regard to treating the real customer fairly. I understand well that many are frustrated by what they describe as the “commission stranglehold” that the advisory community enjoys, but so long as providers continue to compete over the attractiveness of their commission proposition, the fundamental flaws in the present business model will remain.

Of course, while it is right and proper that the industry take responsibility for the business model that it chooses to operate under and the implications of the attendant incentives, the FSA also has a role to play. It will I hope help if I indicate the work which we are considering as our contribution to changing a highly unsatisfactory position. It falls into three parts.

The first is very long term, and relates to our work on promoting financial capability. One of the fundamental problems of the retail market for financial services – for both provider and consumer – is the information asymmetry between provider and customer, which derives in part from the very low levels of financial capability among the adult population...The FSA's work on financial capability will always be a small adjunct to the government’s spend – currently over £42 billion a year on UK education (pre-school, primary and secondary) – to discharge its responsibility to produce literate and numerate citizens. Our challenge is to find where the FSA's spend on financial capability can have a catalytic effect. We have increased our effort here: I expect the FSA's spend on financial capability this year to be £11 million and to run in future years in the range £15-20 million, against £2 million in 2003-04. But, seriously though we are taking this, and important though it is, it will take a decade or more to really work through to being effective.

The second strand of work is what we at the FSA could or should do to provide incentives to firms to develop a business model for the retail financial market which works better than the present model. There are some particular initiatives, which all derive from the treating customers fairly (TCF) programme. We are concerned about the remuneration practices which we have found in many firms which profess to have embraced the principle of TCF, but where the practice appears to run counter to the principle...Our recent thematic work on the quality of advice at financial advisers found that:

• for non sales personnel, at and above managers, bonuses are often linked to growth and profit targets, unadjusted for customer issues;
• for sales personnel, there is a raft of detailed sales commissions which taken in the context of overall performance management frameworks do little to encourage (and may discourage) the fair treatment of customers.

So the first initiative is to encourage firms to develop practices which reinforce, rather than undermine, the principle of treating customers fairly and to take steps to mitigate the risks of unsuitable advice as a result of inappropriate management of performance and reward. Second, there are a number of issues connected to the advice process, where again firms need to adopt practices which deliver TCF. For example:

• only a third of firms’ advisers provided non commission-earning advice before moving on to commission-earning transactions, and of firms which held themselves out as offering a full advice service only a third obtained the information from the customer which would enable them to do so properly;
• there are substantial failings in the recruitment, training and assessment of advisers. We need to see an advisory process which supports treating customers fairly. Too often it does not.

Allied to this, we are also working to establish a better recognition of the responsibilities which exist between different parts of the distribution chain, and in particular between the product provider and the distributor of the product, or a derived product. This is not a simple area, since there are many relationships between product providers and
distributors. A capital-protected structured retail product – the currently popular guaranteed return bond for example – could involve one or more investment banks providing structured derivatives and trading in both equities and bonds; a retail bank which attaches its name to the product; and a distribution network of IFAs. We need a clearer recognition of where responsibilities lie. In particular, we need to avoid a position in which the use of IFAs as a distribution channel acts as a “cut off”, shielding the relevant product provider – in this example the retail bank – from any responsibility for treating customers fairly.

…The final stream of work that I want to mention today aims to move beyond simply identifying issues and symptoms…and instead seeks to address the root causes. Given the central importance of a financial sector that is able to provide the right kind of products in the right way and at the right time to those that need them, we believe now is the time to take a step back and consider the wider context of the distribution of retail financial products. To that end, the Retail Distribution Review announced by John Tiner in June is now well under way…We are ourselves analysing, for various retail financial services, the value chain: Who are the players? How much does each pay, and how? Who makes money? Where does regulation impose costs and where does it add benefits? What are the barriers to market solutions to the points I’ve raised today? In particular, we need to have a better understanding of the costs and the profitability of the business, the sustainability of the current structure, and assess how far those costs are associated with regulation. This will take into account our earlier work on the costs of regulation…we do need to identify regulations in this sector whose costs outweigh their benefits…or not, as the case may be. I am doubtful whether lower regulatory costs will constitute a major opportunity for cost reduction, or for major change to the business model. Indeed, we expect that many of our regulations have longer term commercial benefits that more enlightened firms have already recognized for themselves.

…I have set out how we at the FSA are approaching a business model and business practices…But the main response must come from the industry itself. I, along with everyone else, welcome the ABI’s recently launched Customer Impact Scheme as a step in the right direction for the many life insurers who have signed up to this initiative. But given the gravity of the shortcomings I have pointed to today, I also have to question whether this step is sufficiently purposeful to make a difference on the scale required. I come back to my earlier statement. The principal responsibility for the business model used by firms lies with the firms which use it. I have identified a number of severe failings in the present model, which make it appear unattractive to both providers and consumers of financial services. I have set out what the FSA intends to do. I will be very interested in seeing whether the industry can develop a full and appropriate response – something which would appear entirely in keeping with their repeated statements about their wish to improve their brand and their performance.

Are we heading towards over regulation?
Speech by John Tiner, Chief Executive, FSA
Rendez-Vous de Septembre, Monte Carlo
12 September 2006

...“Are we heading towards over regulation?” …My simple answer is yes…I believe strongly that markets are the lifeblood of successful economies and societies and that only carefully judged regulatory intervention can add to rather than detract from the positive impacts of market forces…

...Rule number one must be that if there are no rational grounds for regulation there should not be regulation. I am moved to wonder whether legislators, regulators and other policy makers derive their job satisfaction and meet their objectives by adding new regulations with insufficient incentives to remove unnecessary regulation…First, is there a failure in the particular market which needs to be addressed? If there is no market failure there is no need for regulation as the market, including the business and consumer participants, can take care of itself.

...Second, if empirical analysis shows there to be a market failure then is regulatory intervention the most efficient and cost-effective form of correction? Market failures can also be addressed using other mechanisms such as competition policy and it is policy makers’ responsibility to consider what is the most effective tool to address a particular situation, taking into account the need to secure specific outcomes and recognising the increase in costs to business and their customers… But even here, the blunt instrument of regulation does not have to be the regulator’s only option, even if there is both a market failure and the benefits have been shown to outweigh the cost of regulatory intervention…
Thirdly, regulators must be very wary of the damaging effects they can have on creativity, innovation and competition. The FSA is an advocate for principle-based regulation – that is where the focus is on the outcomes rather than the prescription of detailed processes… The regulator and the regulated must be bold enough to accept some uncertainty and ambiguity and to manage any consequent legal risks for the good of markets and society as a whole…

So why are we heading towards over-regulation? I have heard it said that too much regulation is a knee-jerk response to a crisis where legislators, regulators and other policy makers need to be seen to be doing something to prevent the same kind of crisis occurring again… The UK financial services industry paid out over £11 billion due to pensions being missold. Something had to be done to restore confidence and protect consumers. I believe the global banking system is safer thanks to the advent of consolidated supervision introduced following the collapse of BCCI in the late 1980s… Sensible, proportionate and fit-for-purpose regulation can be a force for improving not just standards within a sector, but also efficiency and competitiveness…

Efficiency versus Fairness?
Speech by Margaret Cole, Director of Enforcement, FSA
Enforcement Law Conference
16 June 2006

…it has always been the FSA’s objective that its enforcement process should be efficient and effective, and not only be fair… but also be seen to be fair. Is it possible to achieve both of those aims? You could be forgiven for thinking, when you listen to people talk about the enforcement process, that the two are mutually exclusive, that an increase in efficiency must automatically lead to a decrease in fairness or vice versa, but is that really right? Is it the correct premise that fairness and efficiency are to be put on different sides of the scales? I believe this is too simplistic.

To take one example - speed. Concluding investigations more quickly is often, indeed almost invariably, talked about under the heading of increasing efficiency or improving effectiveness. Clearly if we can conclude cases more quickly it is more efficient for the FSA: it allows us to release resources to focus on new priorities. It is also more effective in that, as we have always made clear, one of the principal purposes of the use of the FSA’s Enforcement tool is the deterrent effect that enforcement action can have. That deterrent effect can be significantly reduced if, by the time the outcome of the case is known, the issue is one of historic interest only.

I would, however, venture the opinion that speed is not just about effectiveness or efficiency. In fact it is also an essential component of fairness. Conducting investigations more quickly means that it is more likely that we will be able to ascertain the true facts of the matter - as the recollections of the subject of the investigation and the witnesses will not have been dimmed by time or clouded by hindsight and documentary or other evidence is more likely to remain intact. Further, the costs, inconvenience and pressure that we recognise can be caused by an enforcement investigation will be brought to an end more swiftly. It therefore seems to me that even taking the paradigm example of a matter which could be said to be efficiency driven, there is a clear and indisputable fairness angle to it too.

Of course there can be times when the requirements of fairness will lead to delays in concluding a matter. We absolutely accept, and believe we have demonstrated, in particular, through the Enforcement Process Review that we are committed to ensuring that our process is not only fair but is also seen to be fair. Some of the structural changes we have made in order to address concerns about perceptions of unfairness will add delay to the process, for instance the legal review conducted within the Enforcement Division by a lawyer who has not previously been part of the case team and the consideration of papers submitted to the RDC by its own independent legal adviser. We believe, however, that in contested cases those measures are important to retain confidence in the process. Without that confidence we cannot truly say that the enforcement process is effective. If the regulated community do not believe in the integrity of our enforcement process our decisions will be devalued and their usefulness to us in transmitting FSA messages will be lost.

… I want to talk about the FSAs overall approach to the use of enforcement and, in particular, why certain matters end up in Enforcement when others do not. This is often described as a question of fairness but is also an issue which is clearly related to efficiency and effectiveness.

The starting point here is to reiterate that the FSA is a risk-based regulator. We currently regulate some 30,000 firms and approximately 165,000 individuals. The FSA’s approach to its regulatory responsibilities has to be sufficiently flexible to deal with the very different types and sizes of firms and markets that we regulate… We also seek to address cross-cutting
industry issues across all sizes of firms through thematic work where firms operating in a particular industry or offering a certain product might be selected for a thematic visit. Themes are, in general, selected to enable the FSA to improve its understanding of particular industry areas or to assess the validity of concerns we have about risks those areas may present to our objectives. The Enforcement Division investigates cases arising in all areas and all types of firms. That is because we believe the most efficient way of carrying out statutory investigations and pursuing disciplinary action to support the FSA's priorities is to have a specialist Enforcement Division. The Division, however, while separate, is fully integrated with the rest of the FSA.

You only need to look at the number of Final Notices issued by the FSA to see that the vast majority of rule breaches are not addressed by the FSA taking disciplinary action… Decisions as to what, on a strategic level, might be a suitable area for use of the Enforcement tool are made by supervisory areas.

I want to make it absolutely clear that in considering this, supervisors will take into account a range of factors such as, for instance, whether the issue is one of significance to the FSA – does it pose a threat to our statutory objectives, is it widespread, what would the potential impact of a disciplinary outcome at the end of an investigation be, would it encourage others to improve their behaviour or encourage consumers to take more responsibility for their decisions? How much do we need to do to achieve a deterrent effect in a particular area and who are we trying to deter? Could we achieve the desired effect – which may be an industry-wide or a firm specific effect – by using other tools; what are the cost/resource implications of pursuing particular areas.

Enforcement does not prowl the corridors seeking out potential cases. After the priorities have been decided we do, of course, then discuss, on an individual case basis, whether an enforcement investigation is appropriate and whether there are grounds to appoint investigators.

…There has long been a perception by large firms that the size of firm is directly related to your likelihood of being referred to Enforcement. Similarly, there is a view that if you are selected for inclusion in thematic work undertaken by the FSA, you are more likely than other firms operating in the same area who are not included in the thematic visits, to end up in Enforcement. The first thing I should say is that clearly there is an element of truth in this. We devote far more of our supervisory resources to high-impact firms. Accordingly it is more likely that problems in those firms will be identified through day-to-day supervision work and, given the nature of some of those firms, where such problems are identified the potential impact can be of great significance. Accordingly, an enforcement investigation with a possible disciplinary outcome may be appropriate. That is not to say that simply the fact that a firm is large will by itself be a reason for contemplating enforcement action as a tool to address a particular issue, rather than any other supervisory tool. It is, however, important that there is an understanding of the reality of the way in which we go about our business which may make investigations by Enforcement of larger firms more frequent and for which we make no apology.

So far as thematic work is concerned, the reality again is that work is undertaken in areas which the FSA thinks are important and which potentially present risks to its statutory objectives. There is no presumption that some or all of any sample of firms visited as part of a theme will necessarily be referred to Enforcement. However, where issues are identified in firms which are visited as part of a theme these will be considered for referral to Enforcement as they would if they had been discovered in any other circumstance. And, by definition, the fact that they are in areas that are of importance to the FSA means that, following our risk-based approach through, they are proportionately more likely to result in us determining that an investigation should be carried out by the Enforcement Division than issues in lower priority areas.

This approach is all about how we, as an organisation, can use all of our resources – including Enforcement – effectively and in a targeted manner...

Firms often express some concern about this and about the element of ‘rough justice’ which this seems to involve. Is it really fair that investigators were appointed to look into my affairs and my business when Firm X down the road is doing exactly the same thing and no investigation is being conducted into them?

…Often here I think this complaint of ‘unfairness’ is really about consistency. The reality is, of course, that the circumstances of two firms are never identical. There are infinite variables between firms, their market position, the way they are managed, their relationship with the regulator…as well as in the information we have and when we receive it. This means that judgments can be, and are, made as to whether or not an investigation by Enforcement is an appropriate tool to use in a particular set of circumstances. And let me make it abundantly clear, that particular set of
circumstances includes…an assessment of whether or not a matter that we are looking at…is something which is of concern across the industry.

We often talk colloquially of cases being ‘referred to Enforcement’. In fact the formal step in the process is, of course, the appointment of investigators most commonly pursuant to Section 168 of the Act, which requires that there be circumstances suggesting a breach may have taken place. That means that we could, if we wished to do so, have many more cases dealt with by appointment of investigators whether or not that ultimately led to disciplinary action being taken…We want to reserve our use of our investigative resource for cases where a potential disciplinary outcome might add value to our overall approach in a particular area. You will, therefore, continue to see that most breaches of rules or principles are dealt with by Supervision or tools other than Enforcement…

I would also like to say a word or two on what appears to be a common misconception – i.e. that if you are colloquially ‘referred to Enforcement’ …that is part of an inexorable path towards a formal disciplinary outcome. This is simply not the case. Excluding our threshold conditions cases, in 2005/2006, 37% of matters investigated by Enforcement concluded with no formal disciplinary action being taken. In a further 9% of cases, private warnings were issued. So, you can see, I hope, that we do genuinely commence our investigations with an open mind and with a view to establishing the facts – not pursuing disciplinary action at any cost.

As I hope I have made clear, we accept that consistency in the way we assess which cases should be investigated by Enforcement is important and we accept that we must be fair in this process. We accept that we must look objectively, calmly and fairly at the facts of a particular referral to assess whether or not it meets the test under S.168 for appointment of investigators. But we do not accept that that fairness requires that no firm is ever investigated unless every other firm meeting the same criteria, whether we know about them or not, is also investigated. Nor do we accept that our choice to use investigation by Enforcement and appoint investigators rather than use a supervisory tool in a particular area is a matter which goes to the question of fairness. Rather, it is a question of how we put into practice the FSAs risk-based approach, how we use our resources effectively and efficiently and how we ensure that we are an effective regulator which is about much more than just being an effective enforcer.

FSA - Enforcement Process Review - Report and Recommendations
Chaired by: David Strachan
July 2005 - Summary

The FSA’s enforcement powers are wide-ranging and were debated extensively as the FSMA [Financial Services and Markets Act] passed through Parliament. This review was the most fundamental review of the FSA’s enforcement and decision-making process since the FSMA came into effect in December 2001.

Fairness
“‘The FSA’s objectives for its enforcement process have been that it should be fair and seen to be fair, and that it should be effective and efficient.” The review dealt with decision-making by the FSA (primarily by the RDC - Regulatory Decisions Committee) and not by the Financial Services and Markets Tribunal (FSMT) which is wholly independent of the FSA.

“Some respondents contended that the FSA’s fairness objective has not always been met.” The Tribunal in its judgment in the Legal & General case made some observations about the general operating procedures of the RDC. There was overall support for the retention of the RDC provided changes were brought to its manner of operation. The review also supported the argument from the Financial Services Consumer Panel that “the process needs to be fair not only to those who are subject to it, but must also take into consideration the interests of consumers…No matter how fairly the FSA’s enforcement process may operate in practice, any perception of unfairness will undermine confidence in it.” The review committee were sensitive to the fact that any changes to processes should not undermine those aspects that were working well.

The Review recommended that the FSA should provide:
• a clear articulation of its overall approach to the use of enforcement;
• sufficient checks and controls during the investigation phase to help deliver balance and fairness;
transparency for those subject to enforcement action about the case they have to answer and the evidence on which it is based;
• clarity as to the separation between those who investigate the case and those who decide.

These principles are meant to apply in the context of FSA decision-making, which cannot replicate the processes of a court of law or tribunal. The FSA cannot confer its decision-making responsibilities on a wholly independent body; it must rather take the decisions itself in a fair process.

Investigation
As a risk-based regulator, the FSA must focus its limited resources on those issues which are likely to have greatest impact on its statutory objectives. The Review recommended no change to this approach. But it did make recommendations to strengthen the investigation process: before a case is referred to the decision makers, there must be a thorough legal review by lawyers in the enforcement division who are not part of the investigation team.

Separation
There must be separation between those who investigate possible rule breaches and those who decide whether the conduct in question should be sanctioned. This is required by the FSMA and is effected by the FSA through the RDC. The RDC is part of the FSA board but operationally independent of it. The review recommended that the RDC be maintained and that its membership continue to include practitioners and non-practitioners. The FSA board should also maintain its current policy of neither intervening nor attempting to influence the RDC’s individual decisions.

Objectivity
The principle of separation is essential if the decision makers are to be able to bring independence and objectivity to their deliberations. Considerable criticism was levied against the practice whereby the enforcement case team provided legal advice to the RDC and was able to discuss the case with the RDC following the representations made by the subject of regulatory action.

The Review outlined the following recommendations to strengthen the RDC’s objectivity and independence:
• create a separate legal function to assist the RDC and cease all confidential communication between the enforcement division and the RDC;
• disclose all substantive communications between the enforcement division and the RDC; and
• end the practice whereby the enforcement case team had direct access to the RDC after the conclusion of the representations meeting without the firm or individual being present.

Settlement
The Review also recommended that the principle of separation be applied to cases that are settled. The RDC’s involvement in settlement cases risked blurring its role and undermining the objectivity which it might subsequently need to bring to a case should it fail to settle. The Review therefore recommended that settlement decisions be the sole preserve of the FSA executive. It proposed the introduction of an explicit discount system for those who settled their cases early.

Early settlement is seen as being in the public interest because it enables consumers to obtain compensation earlier and messages to be delivered to the industry sooner. However, due regard must be given to prevent the process from being perceived as unfair or oppressive.

The review proposed a maximum discount of 30% of the financial penalty.

Performance measurement
The most significant influence on how fairly the enforcement process is perceived to operate is the experiences of those who are subject to it. The Review recommended greater transparency of the FSA’s enforcement process ideally by publishing a range of data. The Review also recommended continued assessment of how well the process is operating and suggested that the FSA publish an Annual Performance Account for enforcement at the time of its Annual Report.
FSA Business Plan 2007-08
February 2007

From John Tiner’s Overview:
… This Business Plan sets out our full programme of work for the coming year and the extra resources, agreed by the Board, which are needed to fund it. Our budget will rise by around £27.6m, a 10.1% increase on 2006/07. The main elements of this increase are:

• An increase of £7.4m in our spending on financial capability, taking our total expenditure in 2007/08 to £17.1m. …
• … We have decided to outsource a significant part of our IT operations. This multi-year contract… involves high upfront costs, resulting in a budget for 2007/08 £11.3m higher than our forecast actual expenditure in 2006/07.

In addition, the Board has approved a budget of up to £50m over the next three years to improve the effectiveness of our people and to support the move to a more principles-based approach… The Annual Funding Requirement – the amount of money we will need to raise from firms in fees in 2007/08 – is £300.1m, an increase of 9.5% on 2006/07.

More principles-based regulation
… a more principles based regulatory approach will produce significant benefits for firms, markets and consumers:
• Firms will have increased flexibility to decide which business and operating processes are appropriate to their activities and types of customer. This should eliminate redundant processes, reduce duplication and ultimately lead to lower costs.
• Customers will benefit from firms more attuned to their needs and will receive information from firms which is more fit-for purpose.
• The FSA will be better placed to have businesslike conversations with firms, make risk-based judgements and provide clear, timely and relevant responses to firms’ questions.

Our people strategy
The FSA wishes to place increasing emphasis on recruiting people with direct experience of the financial services industry who have relationship management skills and technical expertise in particular areas. It is carrying out further work to identify the skills needed by staff in each of the major disciplines in the FSA (supervision, policy, enforcement, etc) and is generally raising the expectations it has of its staff.

… as part of this change we envisage headcount reducing by about 300 by the end of the decade. We expect to make significant progress towards this during the coming year. We also plan to invest further in our people by stretching the pay ranges…

From Section 2: Helping Retail Customers Achieve a Fair Deal
The Treating Customers Fairly (TCF) Initiative
Treating Customers Fairly (TCF) is an ‘example of our move to a more principles-based approach to regulation’. The standards the FSA requires the industry to meet as a minimum are not new – they are those described in our Principles for Businesses. Rather than introducing new rules and guidance that limit the ways in which firms’ senior management can meet our standards, it has adopted an outcomes-based approach.

The TCF initiative challenges firms’ senior management across all sectors to review how they treat their customers and to make changes where they find practices which may lead to unfair outcomes for consumers. The FSA wants to see a retail marketplace characterised by the following outcomes for consumers:
• consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture;
• products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly;
• consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale;
• consumers receive suitable advice;
• consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect; and
• consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

The FSA will also continue to challenge firms on the management information they use to satisfy themselves that their customers are being treated fairly. The FSA’s work to date has highlighted a potential gap between the commitment shown by senior management in firms to treat their customers fairly and the outcomes at the consumer interface with the firm. So the FSA will be looking at corporate culture, including organisational and management arrangements that may encourage or inhibit the delivery of senior management aspirations throughout the business. It expects to publish examples of good and poor practice in Q3 2007. The FSA will continue to use its powers under the Unfair Terms in Consumer Contracts Regulations to help ensure that firms are drafting fair contract terms and administering them fairly. It will also continue to take enforcement action, including on the basis of principles alone, where it finds significant actual or potential consumer detriment.
APPENDIX 4

Interim Report of the Committee on Capital Markets Regulation
Chaired by: Glenn Hubbard & John L. Thornton
Director: Hal S. Scott
November 30, 2006
http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf

The Committee on Capital Markets Regulation is an independent, bipartisan group of 22 experts from the investor community, business, finance, law, accounting and academia. It is dedicated to improving the competitiveness of the US capital markets by reducing regulation and litigation while enhancing the rights of shareholders.

Its interim report said: “Maximizing the competitiveness of US capital markets is critical to ensuring economic growth, job creation, low costs of capital, innovation, entrepreneurship and a strong tax base in key areas of the country. Regulation and litigation play central roles in protecting investors and the efficient functioning of our capital markets, particularly in light of recent, highly publicized abuses. Yet excessive regulation, problematic implementation and unwarranted litigation – particularly when occurring simultaneously – make US capital markets less attractive”.

The 32 recommendations cover shareholder rights, Section 404 of the Sarbanes-Oxley Act, the regulatory process and public and private enforcement. The aim is to “give US capital markets the competitive boost necessary to respond to the increasingly aggressive efforts of other nations to attract equity capital markets”.

The competitiveness of US markets
“Companies and investors can now find markets outside the US that are deep and highly liquid. Technology now provides the possibility of easily trading anywhere. Because multiple markets have created choices that never used to exist, issuers seeking capital are now using a cost benefit analysis that focuses on the competitive differences between markets, including the potential cost of litigation and the complexity of regulation…

“While some erosion of the historically immense US market-share of global equity listings, trading and total equity financing is natural, it cannot fully explain why amongst other things, 5% of the value of global initial public offerings was raised in the US last year, compared to 50% in 2000; or why the US share of total equity capital raised in the world’s 10 top countries has declined to 27.9% so far this year from 41% in 1995.”

Maintaining investor protection and shareholder value
“Investor protection is a bedrock principle of US capital markets. The Sarbanes-Oxley Act of 2002 created a new regime of investor protection by enhancing the scope and speed of disclosures. It helped restore market confidence after several high-profile corporate scandals and abuses.

“Investors and companies raising capital participate in markets where they feel safe by reason of effective laws vigorously enforced by knowledgeable, transparent courts and even-handed, vigilant regulators…The question is whether that regulatory intensity has increased to such a degree so as to undermine the competitiveness of US capital markets.”

The impact of regulation and litigation
“The evidence suggests that balance does need to be restored…Regulatory requirements for complying with Section 404 of the Sarbanes-Oxley Act cost companies, on average, $4.36 million in the first year – a stiff price for most public companies and a significant burden for small ones, particularly first time market entrants.

“Nearly open-ended responsibility of auditors in complying with Section 404 has made an already consolidation-shrivelled profession virtually uninsurable for this work…Improper criminalization of entire companies has sometimes forced them out of business…Private enforcement in the form of securities law class action suits…resulted in $150 million of liabilities in 1995. By 2004, this had exploded to $3.5 billion – not including an additional $4.74 billion of penalties assessed by US public enforcement bodies.”

Reducing regulation and litigation while enhancing the rights of shareholders
Shareholder rights: “The Committee believes that expanding shareholder rights will do much to bring about the changes it seeks.”
“Classified boards should be required to obtain shareholder authorization to adopt a poison pill… The Committee endorsed majority, rather than plurality, voting, which is a cornerstone of shareholder rights… Shareholders should be given the choice to decide how disputes with their companies should be resolved… The SEC should resolve issues on ballot access…”

**Regulatory Process:** “Effective regulation that creates a hospitable climate for both investors and companies… depends on the regulatory process that the SEC and other regulators implement to achieve their legislated mandates, as well as on the legislation passed by Congress…”

“The SEC and self-regulatory organizations (SROs) should move to a more risk-based regulatory process, emphasizing the costs and benefits of new rules… [relying] on empirical evidence to the extent possible. Also to the extent possible, regulations should rely on principles-based rules and guidance.

“The SEC should periodically test existing rules to ensure that they still meet reasonable cost/benefit standards. Public enforcement bodies like the SEC, Justice Department and state securities commissioners and attorneys general need to co-ordinate their activities, providing for federal precedence where enforcement implications are national in scope…”

**Public and Private Enforcement:** “Well-policed markets attract investors and corporations seeking to raise capital. Continued civil and, where justified, criminal enforcement against individual wrongdoers, including CEOs with whom the buck must stop, should be supported. Yet some reform is necessary:

“…Criminal enforcement against companies should be a last resort, reserved for companies that have become criminal enterprises from top to bottom. We should not hold outside directors responsible for corporate malefactions that they cannot possibly detect. Public enforcement authorities should not be allowed to threaten corporate defendants with denial of their employees’ right to due process.

“The SEC should protect outside board members against liability from relying in good faith on the validity of audited financial statements – otherwise, it will be difficult to attract independent directors to boards.

“Congress should explore protecting audit firms against catastrophic loss through the provision of caps or safe harbours… Any use of such protection must be balanced against stiff action against those responsible for misconduct.”

**Sarbanes-Oxley:** “…changes in implementation, not statutory change, are necessary. Adjustments in implementation, especially of Section 404, would provide benefits, but at considerably less cost:

“The SEC should adopt a more reasonable materiality standard both for internal controls and financial statements.

“The SEC and the PCAOB should adopt enhanced guidance on auditors’ role and duties in testing for compliance with Section 404. If a revised Section 404 is too burdensome for small companies … even after the… reforms outlined above… the SEC should recommend to Congress that small companies be exempt from auditor attestation and be subject to a more reasonable standard for management certification.”

---

**Principles for Better Regulation**

International Council of Securities Associations (ICSA) - UK contribution by London Investment Banking Association (LIBA)

November 2006


The International Council of Securities Regulation (ICSA) which is composed of trade associations and self-regulatory organisations has published a set of best practice guidelines for improved regulation of the world’s financial markets. The guidelines were developed in response to the “growing and unprecedented regulatory burden” that international organisations now face. The 10 principles highlight the need for an approach to regulation that supports competition and consumer protection while at the same time avoiding unnecessary or excessive regulation.

LIBA reported: “Over regulation of the financial sector is a real threat. In recent years the international financial markets have undergone a plethora of new regulation which at times has seemed unstoppable. Too often regulatory initiatives
The principles are designed to achieve a better overall international regulatory process on a sustained basis, as well as address specific issues of mutual concern to both the industry and regulators… Financial services firms and regulators have a common interest in a regulatory environment that supports economic development and growth, financial stability, customer service and consumer protection.

The committee highlights increasing concern that regulatory complexity and uncertainty may impede achievement of core regulatory objectives. The main concerns are:

- the ability to serve customers better can be hindered by legislative, regulatory and enforcement uncertainty and by excessively prescriptive approaches;
- overly detailed regulations do not promote regulatory effectiveness in a rapidly evolving market;
- inconsistent regulations and uncoordinated supervisory practices decrease regulatory efficiency and create unnecessary burdens for both regulators and firms;

The principles are:

1. Establish first whether there is a significant market failure or financial misbehaviour arising from firms’ conduct, risk management or relations with consumers, which is not appropriately addressed by existing regulations and their enforcement and which is unlikely to be mitigated over a reasonable period of time by market forces.

2. Where market failure or misbehaviour has been established and is unlikely to be mitigated over time by market or other forces or actions, rigorous analysis should be employed, using cost-benefit techniques to the extent possible, in order to determine whether the expected benefits of any contemplated action, regulatory or other, would outweigh the costs or disadvantages.

3. When considering what to do, regulatory policymakers should consider the full range of appropriate responses to a problem before turning to legislative or regulatory measures.

4. Regulations should be targeted, proportionate and risk based.

5. Where possible, regulations should stimulate rather than restrict competition.

6. As far as practical, regulators should rely on stable, principles-based regulations.

7. All regulations should be reviewed from time to time to examine whether they and the market failure to which they were initially directed are still relevant and, if so, whether the measures should be amended, simplified or abolished.

8. Market participants and the general public should be able to influence governments and regulators in the design and implementation of regulatory policy through an effective and structured consultation process.

9. If it is necessary to issue new regulations at extreme speed, those regulations should have an automatic sunset clause that sets a firm deadline for considering whether to abandon the measure or replace it with something permanent, following a structured and effective consultation with the industry.

10. Where two or more regulators operate in a given jurisdiction, there must be proper co-ordination between those organisations.
regulatory safeguards are threatened when rules do not apply equally to regulated and unregulated firms offering comparable products and services;

- legislative and regulatory processes that do not take stock of other stakeholder input may not maximise efficiency and may even result in unintended consequences;

- disproportionate enforcement action can create unintended effects that may have broader regulatory or economic implications for the entire industry.

The IIF believes that firms and regulators have a strong, shared interest in developing and maintaining an effective set of relationships that support economic growth and competition; ensure the stability and security of the financial system; and serve customers' best interests with clear safeguards. These three broad objectives provide a common agenda for action:

- On economic growth and competition, the committee believes that regulation should support the health of the financial system and global economy and encourage development of competitive financial markets. The aim is to promote healthy, innovative and profitable financial firms; open and competitive markets and non-discrimination; customer-driven products and organisational flexibility.

- With respect to institutional safety and soundness, regulation and supervisory oversight should foster the optimal level of structural soundness, financial prudence and risk control of all participants. This will include focusing on prudential capital maintenance, sound risk management, counterparty transparency, prevention of financial crime and crisis prevention.

- Regulation should also foster the right levels of customer service, protection and care, ensuring also customer privacy, customer choice, customer awareness, effective dispute resolution and product availability.

Guidance Principles

Interaction between regulators and the industry should be shaped by the following principles:

1. Mutual trust and respect for judgement.
2. Collective market-based solutions should be preferred whenever possible
3. Global co-ordination of regulation is an essential part of any jurisdiction's regulatory process for firms conducting cross-border business.
4. Maintaining a meaningful legislative dialogue is essential for both industry and regulators
5. Effective and efficient regulation requires assessing policies and new initiatives dynamically.
6. Contingency planning is a joint obligation of the public and private sectors.
7. Proportionate enforcement must be part of efficient and effective regulation.

Firms should focus on ethical leadership, effective governance and effective risk management. They should engage proactively with regulators and have contingency and crisis management plans in place. They should also have appropriate public disclosure and anti-money laundering procedures, as well as procedures to safeguard customer privacy and ensure customers are treated fairly.

Regulators should set clear and articulate goals and encourage regulatory co-operation. They should periodically assess the need and effectiveness of regulation, and should aim to achieve international consistency when developing new regulations. There should be concerted efforts to implement international 'no-action' procedures, building on such procedures where they already exist at a national level, but expanded to make possible multi-jurisdictional ex-ante regulatory advice where appropriate. Regulators are also expected to consider the impact and possible overlap of all new regulatory initiatives for different purposes.

The IIF also believes that regulatory remediation and enforcement should be performance-based and conducted in a way that creates clear incentives for appropriate conduct and equally clear disincentives for inappropriate conduct. Regulators should act proportionately and recognise corporate risk management efforts.
Regulation - Less is More – Reducing Burdens, Improving Outcomes
Chaired by: David Arculus, Better Regulation Task Force (BRTF)
March 2005


The Better Regulation Task Force (BRTF) was asked by the Prime Minister to look at:

1. the Dutch approach of introducing a target for reducing administrative costs to bear down on the paperwork burdens faced by business ;
2. a one in, one out rule for regulation, where new regulations have to be matched by deregulatory measures.

The recommendation was for the Government to adopt both measures. It was estimated that complying with the information requirement of UK cost some £20bn-40bn p.a. This could hamper business, channelling resources away from more efficient uses and acting as a constraint on innovation, productivity and growth.

The approach had three components – measurement of burden, political commitment to a target and an organisational structure that would provide incentives to achieve that target. The recommendations were:

1. Adopt the Standard Cost Model (SCM) and use it to provide systematic measurement of the administrative burdens. The government should set a target for reducing administrative burdens, and put in place the organisational structure and the necessary resources to facilitate measurement and target achievement.
2. Develop robust mechanisms for businesses and other stakeholders to submit proposals for simplification. They should include evidence in support of their proposals and options for reform.
3. Develop a rolling programme to identify regulations that can be simplified, repealed, reformed and/or consolidated. These initiatives should include proposals to reduce administrative burdens, revisiting the implementation of EU directives and post-implementation reviews of all major pieces of legislation.
4. Undertake an RIA for all major regulatory proposals, these should be accompanied by compensatory simplification measures.
5. Review of the Regulatory Reform Act to consider whether it can be widened to allow more reforms to be delivered by Regulatory Reform Order (RRO)
6. The government should provide parliamentary time for a Deregulation Bill.
7. By April 2006, the government should extend the use of common commencement dates to other policy areas and include implementation of simplification measures as well as new regulation.
8. The Government should develop a methodology for assessing the total cumulative costs of regulatory proposals.

Reducing administrative burdens: effective inspection and enforcement
Chaired by: Philip Hampton
March 2005

http://www.hm-treasury.gov.uk/media/A63/EF/bud05hamptonv1.pdf

The Hampton review was initiated by the Treasury in 2004 to consider the scope for reducing administrative burdens by promoting more efficient approaches to regulatory inspection and enforcement, without compromising regulatory standards or outcomes.

The review identified the following issues:
The Commission has launched a major simplification programme for 2005-2008 with more than 100 initiatives to review laws on the book. The European Parliament and the Council have signed the Inter-institutional Agreement on Better Lawmaking and are taking steps to apply Better Regulation in practice. Progress at member state (MS) level has accelerated since the adoption of the Integrated Guidelines for Growth and Jobs with 19 of them having introduced or about to develop a Better Regulation Strategy and 17... measuring administrative costs.

Several MS have set global targets for reduction of administrative burdens. Impact assessments are being conducted more widely, although they are often partial. Nine have simplification programmes and eight have ad-hoc simplification initiatives. However, consultation is obligatory in only nine MS...Given that administrative burdens originate both in European and national legislation, the Commission proposes that the Spring 2007 European Council fix a joint reduction target for administrative burdens of 25% to be achieved by 2012.

Commission: Better Regulation programme
For existing legislation, efforts are being made to simplify and modernise the acquis communautaire through legislative techniques such as recast, repeal, codification or revision. For new proposals, there is a comprehensive system for assessing impacts...

Implementation issues are being more carefully looked at in the design of policies and laws as well as in their review and possible amendments. The exercise is about delivering high quality regulation in the best way possible, not deregulation.

Progress to date
Modernising the stock of existing legislation: one in, 25 out. There has been a simplification of existing legislation,
particularly targeted at reducing reporting requirements.

MS experience demonstrates that public authorities can do a lot to reduce unwarranted administrative burdens of legislation: economic benefits are estimated at an increase in the level of GDP of up to 1.5%, or €150 billion. The Commission has developed a common methodology for assessing administrative costs and applies this in its own ex-ante impact assessments for new legislation.

Improving the preparation of proposals: ...an important part of making better laws is having a full picture of their economic, social and environmental impacts, including the international context. Since 2003 the Commission has completed more than 160 IAs. An important new element to improve decision-making is the creation of an Impact Assessment Board (IAB), which will offer advice and support in developing a culture of impact assessment inside the Commission.

Applying EU law: Efforts made by the Commission to simplify and improve the regulatory environment will not deliver the desired results unless European laws are applied correctly and effectively in the MS. The Commission will take more preventive action, following-up with MS at an early stage so as to facilitate the correct transposition of key directives. Where prevention fails, the Commission will seek swift correction.

Next Steps – the way forward
Simplification of legislation: A rolling simplification programme will be integrated into the Commission's Legislative and Work Programme. In addition to this, more than 40 additional simplification initiatives are on the agenda.

The Commission will propose an Action Plan on Measuring Administrative Costs and Reducing Administrative Burdens as well as launching a large measurement and burden reduction study. The spring 2007 European Council meeting will be asked to endorse a joint 25% reduction target.

The IAB will start to systematically review Commission impact assessments and its work will be extended under the 2008 review of the Common Approach to Impact Assessment.

The screening and withdrawal of pending proposals and the transposition and application of EU Law: During 2007 the Commission will propose a new initiative to reinforce its efforts to anticipate and prevent transposition problems, through enhanced co-operation with MS. Some measures dealing with the codification and repeal of existing acts also figure on the agenda.
Template for Mortgages
Draft from CSFI

What is a mortgage?
According to the Financial Services Authority: “A ‘mortgage’ is a loan secured against your home. ‘Secured’ means that if you do not keep up the payments, the lender can sell your home to get its money back.” See www.fsa.gov.uk/consumer

The loan
The loan is over an agreed period and must be repaid by the end of it. The longer the period is, the more you pay because of the increased interest bill. There are two ways to repay the loan:

a) In instalments alongside your monthly interest payments: a "repayment mortgage". You are certain to repay over the agreed term but the repayments are not equal. In the early years the debt shrinks slowly because interest costs take up a large part of your bill. Later on the mix of interest and repayments alters and the debt shrinks more swiftly.

b) With a lump sum that you acquire or save up for. In this case your payments to the lender are “interest only”. You will be left with a shortfall if your savings/investments do not grow enough to repay the loan. This is what happened with endowment mortgages when the stock market fell.

The amount you can borrow depends on the value of the property and your income. The first matters because if you fail to keep up payments, the lender will seize your house and sell it to recoup the money owed. The second determines whether you can afford the monthly payments. The risks are that your income may not increase as fast as interest rates and/or that your other spending may rise, reducing your payment capacity.

The interest
The lender charges interest on the loan. These charges are competitive. Each lender has a “standard variable rate” (SVR), which rises and falls with interest rates elsewhere in the economy, notably the Bank of England base rate. You can obtain variable rates at a discount to the SVR. You can also fix your rates. These arrangements are usually for much shorter periods than the length of your mortgage and carry various restrictions. When the arrangement expires your interest bill will revert to the SVR unless you seek a new arrangement.

Other fees
There will be other fees related to the property survey, the type of product you choose and other administration charges. If any of the conditions of the loan are breached, there may also be penalty fees. Check the smallprint.

The target market
People who want to own their home and invest in residential property.

Do you have:

• A deposit? This reduces the risk that the value of the house will fall below the amount owed. Higher deposits attract fewer fees and conditions.

• A regular income*? This must cover monthly payments to the lender and all your other spending.

• Income that is likely to last*? The nearer you are to retirement, for instance, the shorter the mortgage term should be.

• A sufficiently large gap between income and unavoidable spending to cover higher (eg 30%) monthly payments to the mortgage lender?

*Insurance policies are available to cover mortgage payments in the event of an unexpected loss of earnings. But this adds to the costs of home ownership.

Different types of Mortgage Repayment
Repayment
Repayment is the least risky but carries higher monthly payments. It is aimed at those who want to be sure that the loan will be repaid and who do not wish to rely on any other way of achieving this.
Interest only
Aimed at people who cannot afford the monthly loan repayments or prefer to repay the loan in another way:

• Are you certain* you can repay the loan later? This may be possible through an inheritance or by selling other assets.
• Are you certain* you will be able to sell the house for more than you owe the mortgage lender plus all the transaction and moving costs?
• Are you prepared to make payments into an investment account? And do you believe* the returns, net of fees, will be sufficient to make this pot of money grow enough to repay the loan? Safe investments, such as government bonds, will not achieve this. Riskier ones, such as equities, may or may not do so.

*What happens if you are wrong?

Variable, fixed, discounted or tracker

• Variable is aimed at those who have sufficient flexibility to absorb higher rates so that they can receive the full benefit when rates fall.

• Fixed, or capped, rates are aimed at those who want certainty of monthly outgoings, or at least a ceiling on future interest costs. In return, they give up the opportunity to take full advantage of falling rates.

• Discounted rates: aim to attract or retain borrowers. The terms are good but the timeframe limited and restrictions apply during the discount period.

• Base rate trackers fix the margin (difference) between the Bank of England base rate and the rate the borrower pays the lender. This margin tends to be lower than that between the base rate and the SVR. Check for restrictions.

The main risks

• You may lose your home if you do not keep up payments

• The value of the house may fall below the amount owed to the lender

• Interest rates may rise sharply

• Your income may fall and/or your outgoings may rise so that you can no longer afford the monthly payments

• Any investment you are counting on to repay the loan may fall short

• Any lump sum that you anticipated eg inheritance may not materialise

What may an Investment Firm Expect from you as a Client?

Association of Private Client Investment Managers and Stockbrokers (APCIMS)

Investment firms are subject to high-level Principles and many detailed rules that govern their relationship with you, as a client of their firm. One Principle is the requirement to "treat the customer fairly". Investment firms have embedded processes and procedures designed to do this, but the law and regulations assume that both you and they bear a responsibility for successful and effective dealing with one another.

In order to fulfil their obligations to you, investment firms are entitled to expect you to take reasonable care in your dealings with them. You would be failing to take reasonable care if, for example, you withhold important information or provide inaccurate information. Omitting to read product particulars or not implementing fully a package of interrelated investment proposals would also be a failure to take reasonable care; as would failure to take into account relevant advice simultaneously being received from other professional advisers, such as accountants or lawyers.
In order to protect your own best interests, please consider the guidelines set out below (though not all will be relevant in every situation) and remember to ask questions at the start and to say if you are uncertain and if there is anything that you do not fully understand.

• Do read any promotional material, explanatory documents and other material, particularly that required by regulation, carefully and with reasonable caution, being alert to offers that seem too good to be true and being clear as to any commitment you are taking on;

• Do engage, with appropriate assistance from the firm, actively and attentively in any fact finding process;

• Do provide openly, and as accurately as you can, material facts and attitudinal information as the firm requests;

• Do read and reflect upon any letter of advice or summary of objectives provided by the firm to ensure that it properly reflects the discussions you have had;

• Do make the most of the protection provided by any right to cancel a purchase during any “cooling off” period (this applies only to certain services and investments);

• Do continue to review your financial needs and position on a regular basis and notify your investment manager or consider obtaining further advice where there has been a material change in personal circumstances; and

• Do complain to a firm and seek redress where you believe you have not been fairly treated at any stage in the process, and, if necessary, go to the FOS or courts.

If you do all these things, then you ought to have maximised your chances of:

• making a good decision that is in your own best interests;

• protecting yourself against any improper or poor quality behaviour by an investment firm; and

• putting yourself in a position to tell as good and persuasive an account as possible of your own actions and thoughtfulness to a court or ombudsman, should any dispute over the transaction go that far.

Your investment firm will be happy to discuss any of the issues raised in this note.

This briefing note has been prepared by APCIMS, the Association of Private Client Investment Managers and Stockbrokers, and is designed to assist individuals in their relationship with investment firms.

Examples of good and bad regulation
Suggested by the working group

Examples of good regulation

• Principles-based regulation, such as the FSA’s prudential sourcebook for insurers, setting out rules governing solvency and reserves, and Treating Customers Fairly, a principle accompanied by illustrations of good practice.

• Industry-driven, or self-regulation, with the Panel on Takeovers and Mergers as the shining example. Operating through a Code, it is seen as non-legalistic, working with the grain of the market and good at giving guidance.

• International convergence, accommodating the cross-border nature of business, eg Basel 1, achieving an international standard for banks’ capital adequacy.

• Rules that keep up professional standards, eg requiring independent financial advisers to be registered and the approved persons regime.

• Intelligent copy out of EU directives.

Examples of bad regulation, or over-regulation

• Too prescriptive, eg the new general insurance regime: the FSA prescribes that the person actually needs the policy, but people often buy things they do not strictly need – a nervous industry over-complies, leading to
complex and costly documentation. Eg the Prospectus Directive: bond issuance is now not in retail denominations because of cost and complexities of marketing to consumers.

- The regulatory net is cast too wide eg general insurance intermediation: 35,000 firms covered, from large retail banks to vets, yet travel insurance is excluded. What is the principle here? Eg applying depolarisation rules on disclosure of sales commission to advisory investment management business, which charges for a service rather than a one-off commission for a product sale.

- Gold-plating, especially of EU regulation eg the Market Abuse Directive and over-prescription on the list of insiders to a deal. Eg implementation of Distance Marketing and other Directives about the sale of retail insurance, leading to lengthy scripts for telephone sales.

- Overlapping regulation, eg liquidity management rules: overlaps with the minimum solvency requirement.

- Intrusive enforcement, eg “close and continuous” monitoring of large firms involves FSA in day-to-day management, diluting management responsibility.

Other, more general, examples of a negative approach:

- Risk aversion: Because consumers do not understand, or are reluctant to accept, the risks involved in financial products, they expect compensation if something goes wrong. Criticism of firms by politicians and the media reinforce this. The result is a hyper-active and prescriptive regulator, which is reluctant to give guidance let alone provide safe havens; and a nervous industry that tries to cover its back by seeking more detailed, legalistic rules.

- Over-protection of the consumer, eg lack of progress on financial literacy, means that the idea of caveat emptor is sacrificed and firms fall back on producing long, legalistic documents. Eg the Prospectus Directive and increased regulation of general insurance sales, as mentioned above.

- Over-zealous enforcement, either through a desire to make an example of a “big fish” or through the need to get a result, which some see as a response to political pressure.

- Anti-industry stance: The FSA behaves as if the industry is “unclean”, and so it is on a mission to clean it up. This perpetuates the industry’s reputational problems.
This report was prepared with specific financial support from the following institutions:

- Resolution plc
- National Australia Group
- International Capital Market Association
- JPMorgan Chase
- Arbuthnot Banking Group
- Winterflood Securities
- ABC International Bank
- Close Brothers Group plc
- Morgan Stanley
- Henderson Global Investors

The CSFI also receives general support from many public and private institutions, and that support takes different forms. In 2006 and so far in 2007, we received unrestricted financial support from:

- Accenture
- Barclays Group
- Citigroup
- JPMorgan Chase
- Abbey
- Aberdeen Asset Management
- Alliance & Leicester
- Aon
- AVIVA plc
- AXA
- Bank of England
- BT Global
- City of London
- CRESTCo/Euroclear
- Deloitte
- DTCC
- Ernst & Young
- Euronext.liffe
- Eversheds
- Fidelity Investments
- Finance and Leasing Association
- Financial Services Authority
- Fitch Ratings
- Futures & Options Association
- Halifax plc
- HM Treasury
- Association of Corporate Treasurers
- Bank of Italy
- Banking Code Standards Board
- Brigade Electronics
- Chown Dewhurst LLP
- Clifford Chance NY
- FSA Solutions
- International Financial Services, London
- Morgan Stanley International
- Pricewaterhouse Coopers
- UBS
- HSBC Holdings plc
- International Capital Market Association
- KPMG
- Law Debenture Corporation plc
- Lloyds of London
- Lloyds TSB
- London Stock Exchange
- Man Group plc
- McKinsey & Co
- Monitise
- Moody's Investors Service Ltd
- Nomura Institute of Capital Markets Research
- PA Consulting
- Prudential plc
- Record Currency Management
- Reuters
- Royal Bank of Scotland
- Standard & Poor's
- Swiss Re
- Z/Yen
- Zurich Financial Services
- Lombard Street Research
- NM Rothschild & Sons
- Preroy AG
- The Housing Finance Corporation
- The Share Centre
- Threadneedle Investments
- Watson Wyatt
- Winterflood Securities Limited

We also received important support in kind from, *inter alia*:

- EFG Private Bank
- Financial Times
- GISE AG
- Linklaters

The CSFI also received special purpose support during 2006/07 from, *inter alia*:

- Cisco Systems
- Cityforum Limited
- Clifford Chance
- Corporate & Financial Group
- Esmee
- Farrer & Co
- Herbert Smith
- IFS School of Finance
- NYU in London
- Open Europe
- Optimum Population Trust