Waking up to the FSA
How the City views its new regulator

by David Lascelles
The Centre for the Study of Financial Innovation is a non-profit think-tank established in March 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.

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Preface

When the Financial Services Authority was just a twinkle in the eye of a Labour opposition that was starting to contemplate its priorities for the City of London, the CSFI was in the thick of the debate – publishing two papers (by Michael Taylor) that supported a “twin peaks” approach to regulation. These advocated a bifurcated regulatory structure – one “peak” for prudential/systemic concerns and another for conduct of business/consumer issues. In the event, Gordon Brown (predictably) paid us no attention whatsoever, and pressed right ahead with his own unitary regulatory structure – a single “peak”, with Sir Howard Davies sitting on the top.

Although we still have some sympathy for the “twin peaks” approach (which got more support in Australia), we don’t hold a grudge. Indeed, we (like everyone else) are enormously impressed by what Sir Howard and his colleagues have achieved in so short a time.

But, since we get around a bit in the City, it is impossible not to be aware that there is a certain amount of dissatisfaction. Much of this is undoubtedly sour grapes; some of it is just an atavistic hankering after an easier life. But some of the complaints that we heard are obviously serious, well-thought out and deeply held. They include, in particular, a belief:

• that the City is moving inexorably away from its tradition of “light-touch” regulation towards a more onerous and expensive rules-based system, in which only lawyers and the burgeoning compliance profession will benefit;
• that the City has been sold a pup – in that it was promised that regulatory change would be minimal, only to discover that the upheaval has been massive, fundamental and apparently perpetual;
• that the FSA has only managed to keep its pledge to sit on costs by sleight-of-hand – effectively, transferring the cost of regulation from the regulator to the regulatee through a huge increase in the cost of compliance;
• that the FSA’s spanking-new risk-based approach to regulation can easily discriminate against smaller firms and start-ups – which traditionally have been the drivers of innovation in the City;
• that melding wholesale and retail regulators into a single institution has led to the heavier-handed “PIA culture” steadily driving out the less prescriptive “Bank of England/SFA culture” – even in wholesale or inter-professional markets;
• that, linked to this, the FSA pays more attention to politically-connected consumer groups than it does to its own practitioner panels;
• that the very high levels of staff turnover at the FSA have made it difficult for regulated firms to develop a trust-based relationship with their individual regulators, who may change from visit to visit;
• that the FSA’s much-vaunted commitment to transparency is a bit of a fraud – putting out 85 discussion papers for comment means letting so much light in that everyone is blinded, and no one can see anything; and
that the potential power of the FSA is so enormous that it is hard to see any successor to Sir Howard (who appears to have demi-god status in the City) continuing to keep the malign influence of rampant bureaucracy in check.

Bringing all this together, there is a pervasive feeling in the City that the new regulatory structure and the way it is administered could begin to undermine the City’s international competitiveness.

We didn’t (and don’t) endorse any of these complaints; we have tried to approach the issue from a completely agnostic point of view. But we did feel that, with N2 coming up and with the transition to full statutory authority underway, it would be worth looking at the City’s concerns. In our view, these are the main concerns that are floating around; if not addressed or challenged, they could easily undermine the confidence on which much of the City’s success is built.

To sort out the wheat from the chaff, my colleague David Lascelles (whom many of you will remember as the banking editor of the Financial Times) spent a great deal of time talking to key figures in the City - as well as with the regulators themselves (for whose support in this venture we are very grateful) and the trade associations. The result (as with anything David writes) is a good read. But it is more than that. It is an attempt by someone who has been a close observer of the City at the highest level for almost 30 years to sift out those concerns that do have merit from those that are congenital whingeing, and to point out the implications for the City in what is bound to be an increasingly competitive – and global – financial market. It is an important and timely piece of work.

Andrew Hilton
Director, CSFI

About this report
This report is based on interviews with 37 City and public institutions, supplemented by responses from a further 40 to a questionnaire (reproduced at the end of the report). A draft was circulated for comment, and then discussed with the FSA before publication. Although the report reflects the views of a large number of people, the judgments it makes are mine. My thanks are due to the many people who contributed views, comment and information.

DL
Executive summary

This report provides a City view of the Financial Services Authority as it prepares to assume its full powers as the UK’s integrated regulator in the latter part of 2001, having been a “virtual” regulator for the last four years. The report is based on interviews and written responses from over 70 City and public institutions.

The report shows that there is a pervasive mood of discontent in the City with the FSA: people find it bureaucratic, intrusive and insensitive, and this is breeding concern that the City might lose the light regulatory touch which has always been one of its strengths.

On closer examination, some of the City’s discontent can be explained by short run factors:

• the City was unprepared for the amount of change brought on by the FSA, particularly the tougher responsibilities it places on management (some parts of the City might even be said to be in a state of shock);

• the FSA itself is not yet fully formed, and some of the reassuring policy statements on flexibility made by its directors still need to be implemented in practice; and

• the FSA’s “risk-based approach”, which contains the promise of less intensive regulation for lower risk firms, is still being phased in.

Unpopularity does not necessarily mean the regulator is doing a bad job. But there are, nonetheless, longer run concerns:

• Although the FSA wants to avoid being over-prescriptive, there are inexorable forces driving the City towards rule-bound regulation. Some of them stem from the statutory nature of the FSA itself. But some stem from the City’s own desire for regulatory certainty as a protection against the FSA’s wide enforcement powers.

• Although the FSA’s new Handbook is shorter than the sum of the rulebooks that preceded it, it is still several feet thick and a monument to rule-driven regulation. A rare opportunity has been missed to cut the rule book back and deploy alternative ways of influencing behaviour, such as greater competition and disclosure.

• Relationships between City firms and their regulator are shifting from a personal to a legalistic footing. People are wary of opening up to the FSA, and of sharing information other than on a must-know basis. This weakens the rapport that the FSA wants to establish with the City.

• Although the FSA itself is run on a tight budget, regulatory costs are rising in most parts of the City because of higher compliance needs. Costs weigh particularly heavily on smaller firms.

• There are fears that the new regime may turn out to be less hospitable to innovation and new company start-ups, though the FSA shows a keen awareness of this risk.

However there are also positive aspects to the new regime:

• The City is coming round to the idea of a unified regulator. It sees the logic of a single structure, and expects to gain from the streamlining effects and better allocation of resources and skills. Large diversified financial groups are already benefiting from the “one-stop shop”
• Although there are concerns about the inflexibility of “one-size-fits-all” regulation, the FSA has shown a willingness to differentiate between professional and consumer interests. If there has been a loss in regulatory diversity, it is offset by greater consistency.

• At the international level, the FSA is seen as a pioneering institution, and is having a growing influence on the debate about cross-border financial regulation. It is described by international firms as the most sophisticated and approachable of the leading financial regulators.

• There is no evidence that the creation of the FSA has damaged London’s competitiveness as a financial centre or cost it business. London remains the financial centre of choice in the European time zone, with the quality of regulation frequently cited as a reason.

Overall, the FSA can be viewed as a potential “plus” for the City because it provides a more appropriate form of regulation for a major international centre. However it is hard to escape the conclusion that light touch regulation is under threat. The pressures are all for more rules and less discretion. But the FSA is still at a formative stage; as it beds down, it could develop more sureness of touch which will help preserve some of that flexibility, and build a stronger rapport between City and regulator.
Waking up to the FSA

Introduction

Just before Christmas 2000, the UK’s Financial Services Authority held a conference at a London hotel to lay out its new regulatory strategy. Over 800 people turned up, prompting Sir Howard Davies, the FSA’s chairman, to joke that a collective noun was needed to describe an assembly of compliance officers: a manual? a tribunal?

Such a massive attendance would have been unthinkable a few years ago. But times have changed. The new Financial Services Authority is already the most powerful regulator in the UK; some people even think it may be the most powerful regulator in the world. A banking lawyer we spoke to from the US, a country not without powerful regulators of its own, described the FSA as “a Goliath”.

This report provides a view of this impressive new authority as it prepares to take over full statutory regulation of UK financial services in the latter part of 2001. How is it shaping up? What sort of a body is it developing into? Will it be good or bad for the City?

Some cautionary notes

First, we initiated this report because we were picking up a growing number of complaints about the new regulator from the City. So we started out with certain pre-conceptions: the FSA was not popular. But why? This report tries to understand the reasons, and ask whether they are well-founded.

Second, although it lives and moves, the FSA will not have its being until N2, the date - probably in November 2001 - when it is vested with its full powers. Until then, it will continue to be an amalgam of the many regulators which went into it. This should qualify any judgments about its character and effectiveness as a single regulator.

Third, although our focus is the City, we recognise that it is unfair to detach one objective from the many that the FSA has been set. Now that the UK has consolidated regulation, the pressures of consumer protection and events like the Equitable Life affair all have to be taken into account. In fact, the City does not even appear as an explicit item on the FSA’s brief, which makes our focus doubly unfair. Yet we offer no apology for assuming that the City’s health and success are central to the FSA’s work.

The FSA’s approach

The FSA faces many challenges. Much the most important from the City’s point of view is to deliver effective, cost-efficient regulation without losing London’s traditionally light regulatory touch. How will it strike this balance?
The FSA has promised a regime which,

- while inevitably involving changes, will provide as much continuity as possible;
- will be based on “high level principles” rather than detailed rules;
- will put the main responsibility for controlling risks on the firms themselves; and
- will focus resources on the areas most likely to pose risks to the FSA’s objectives of delivering efficient, orderly and clean markets, and helping retail consumers achieve a fair deal - the so-called “risk-based approach”.

This game plan has gone down well in the City. Virtually everyone we spoke to thought it looked sensible and pragmatic: above all, it demonstrated an intention to preserve the light touch. But most of the people we spoke to also said - in tones ranging from annoyance to rage - that their practical experience of the FSA had been rather the opposite: they had found it bureaucratic, nosy, heavy-handed, costly. And few of the benefits they had been promised were coming through.

These negative feelings can probably be attributed – in part at least – to the wrench of adjustment to a new regulatory regime, and will therefore ease once people get used to it. Some can also be put down to culture shock; while the FSA was a long time a-coming, its actual arrival has clearly caught a lot of City people by surprise.

But some of the concerns expressed by our respondents also go deeper: people are worried that the arrival of the FSA marks a permanent turn for the worse in the City, that light-touch regulation is heading out the door, and that the City will end up a loser. Are these fears justified?

**Continuity and change.** The birth of the FSA has brought not just a new regulator with wider powers, but a whole new style of regulation which has obliged City firms to embark on sometimes far-reaching changes: e.g. toughening up their control systems, training people, defining responsibilities. They are also having to take on board new regimes introduced by the Financial Services and Markets Act to combat market abuse and money laundering. The FSA’s contention that it is not asking for anything that well-managed firms would not be doing anyway is widely dismissed. “The FSA greatly underestimates the impact of what it is demanding”, was typical of comments we received.

We found a lot of City people under the apprehension that the FSA had promised a minimal amount of change. In fact, the FSA never made any such promise. If anything it warned that the new regime would mean considerable changes, though it did promise “to proceed at a measured, manageable pace”.

**Flexibility.** The new regime is supposed to be flexible and responsive, but this is not what firms have always found, despite the FSA’s emphasis on high level principles and a hands-off style. Many people criticised the FSA for its bureaucratic manner, and its monumental Handbook – what one of them called its “kitchen sink” approach.
The FSA - the facts

The Financial Services Authority was launched by the new Labour government shortly after its election victory in 1997 to provide one-stop, statute-based regulation of the whole UK financial services sector: commercial banking, investment banking, stockbroking, building societies, financial markets, financial advisers, insurance etc. The rationale was that the different sectors of the finance industry were merging together, and regulation must follow. Also, old-style City regulation was no longer up to the job of policing fast-moving global markets.

The FSA was created by the Financial Services and Markets Act 2000 (FSMA) and will assume full control of financial regulation in the latter part of 2001. Its statutory objectives are to deliver:

- market confidence;
- public awareness;
- the protection of consumers; and
- the reduction of financial crime.

But in carrying out its work, the FSA must also have regard to a number of statutory criteria such as the efficient use of resources, keeping costs and benefits in proportion, encouraging innovation and maintaining the international competitiveness of the UK financial services sector.

The merging of regulators is already well advanced: the Bank of England’s banking supervision department, the Building Societies Commission, the Insurance Inspectorate of the Department of Trade and Industry, and the self-regulatory bodies which oversaw the City’s investment business are now all under one roof.

The merger has produced much streamlining:

- ten regulators have been reduced to one;
- 14 rule books have been reduced to one;
- 13 prudential regimes have been reduced to four; and
- 15 liquidity regimes have been reduced to two.

The FSA occupies a 15-storey building in the City’s “extension” at Canary Wharf. It employs 2,030 people and has an annual budget of £164m. Its regulatory aegis covers 660 banks, 7,500 investment firms, insurance companies with annual premiums of £48bn, and nearly 40,000 investment advisers. The value of the funds owned or controlled by FSA-licensed institutions amounts to over £7,000bn, and the segment of the British economy it covers contributes about 5.8 per cent of UK GDP.
The principles are generating new rules

But we also found that the shift towards a more rule-bound system is not altogether the FSA’s fault. The City itself is hungry for rules.

The difficulty lies in the fact that the FSA’s broad principles may satisfy the City’s desire for flexibility, but they do not answer its need for regulatory certainty in a regime backed by powers to fine and prosecute. The FSA would like to be able to say to the City: “Abide by these principles and you will be OK.” A typical principle says: “A firm must conduct its business with integrity”, which is good but rather short on detail. So the City goes back to the regulator and asks: “Will it be alright if I do this?” The FSA responds by issuing rules or guidance. More firms go back with questions, more rules get issued. Lawyers, uncomfortable with broad statements of principle, press for detail.

The FSA Handbook

The FSA’s rules and guidance are contained in its “Handbook”, a word which suggests that it can be slipped into the pocket and read on the train. In fact, it is several feet thick and its contents will never be capable of being absorbed by a single individual.

The FSA has made it more user-friendly by including plenty of signposts and “navigation” aids, but a small industry has already sprung up among City lawyers, consultants and trade associations to slice the Handbook into relevant bits and provide learned interpretations. This will be a permanent industry since the Handbook will never reach a final state: it will be constantly updated.

One consolation: the FSA says that its Handbook, at least in its present size, is smaller than the sum of the 14 handbooks that existed under the previous regulatory regime. It will also be issued in an electronic version which will make it easier to transport and navigate.

Pretty soon, the clear space that the FSA wanted to leave around the principles becomes stuffed with rules and regulations, and the light touch is gone. A respondent said: “The principles should be a restraint on the introduction of new rules. Instead it’s turning out the other way round: they trigger new rules all the time.”

This process of constant fleshing out of what were intended to be simple rules is a familiar phenomenon in the regulatory world. But what is disappointing is that the FSA appears to have missed a golden opportunity to prune the City rule book right back once-for-all. There are other ways of promoting financial soundness and good customer service, such as enhanced disclosure and competition, but these have been given short shrift.

Risk-based approach. The risk-based approach contains the promise that the FSA will be judgmental rather than bureaucratic in style. Under this approach, the FSA will assess all the firms it authorises, and rank them A to D according to the risk they pose to its statutory objectives, i.e. do they threaten market confidence, do they endanger consumers or open the door to financial crime? The promise is that firms lower down the risk scale will end up being less intensely regulated than those higher up - which is good news, at least for those lower down the scale. And according to the FSA, 80 per cent of the 8,500 firms it authorises will end up with the lowest risk rating: D.
Market abuse

Many of the City’s worries about regulatory certainty have crystallised around the FSA’s rules to outlaw insider trading and market manipulation. These activities are notoriously difficult to nail down, and the City wants to know exactly what the FSA means by them.

The Act requires the FSA to apply a “regular user test”, i.e. would a regular user think a particular incident amounted to market abuse? To elucidate, the FSA recently produced a Code which contains examples. But the list is not exhaustive, and the City wants more.

The FSA says it will resist being drawn down the road of detailing every instance to avoid creating what it calls “a loophole-seeking mentality”.

But the assessment process itself is laborious and sometimes intrusive because it involves site visits by FSA teams which some City firms have found aggravating (even though the FSA says that most of the work is desk-based). We also heard complaints about the FSA’s “box-ticking” attitude. One respondent noted that the FSA is supposed to measure risk by balancing the damage of a possible disaster against the likelihood of it happening. But in his experience, FSA officials spent more time calculating the likely damage than the likelihood of the event actually occurring. “It’s a cover-your-backside mentality” is how another described it. This is breeding fears that the FSA will find it difficult to leave firms alone, even the low risk ones. So the risk-based approach could end up being bureaucratic after all.

Some people think that the FSA’s bureaucratic tendencies reflect a lack of institutional self-confidence: people at the authority do not yet feel secure enough to exercise judgment and show the flexibility the City is looking for. Nick Weinreb, who heads compliance at Liffe, said: “The weight of the regulatory touch depends not on the rules but how they are applied.”

Paul Nelson, who heads the financial practice of City lawyers Linklaters & Alliance, thinks that the FSA’s proliferating rulebook is a sign that it is afraid to use its judgment. A bolder stance by the regulator would achieve the seemingly conflicting demands from the City for both management freedom and regulatory certainty. “The FSA should take responsibility and say: ‘These are my priorities, and I’ll focus on them with these rules.’ Instead, it is writing thousands of pages of legally drafted rules in an attempt to leave nothing to chance,” he says.

Enforcement. One of the City’s greatest fears is of the, as yet untested, enforcement regime of the FSA.

The City wants to be sure that the FSA will act reasonably, and that the built-in checks will be effective. However, the fear of enforcement is already beginning to colour firms’ relationships with the FSA, particularly when it comes to sharing information. “We want to be open with them, we have nothing to hide. But we now worry that everything will go on file. It makes you scared to talk,” said a compliance officer. The result is that only “must-know” information gets offered. The FSA’s response has been to say: “Trust us. We will do the right thing.” It has also issued a consultation document explaining how its powers will be used. But these comforting words have not allayed the City’s fears. This really is an area where the test of the FSA pudding will lie in the eating; much would be damaged if the relationship between regulator and regulated got off on the wrong foot.

A lack of institutional self-confidence
Too many rules?

The FSA has promised the City to keep regulation in proportion, but few of its rules have caused quite such aggravation as those laying out the responsibility of senior management for - er - complying with the rules.

The purpose of the rules is to pin down responsibility in firms, and get rid of the “not on my watch” syndrome that tends to pop up when things go wrong. The FSA’s original consultation papers received nearly 300 responses, prompting its drafters to soften their proposals. Even so, the so-called SYSC Rules contain detailed guidance to ensure that firms have the right systems and controls, that responsibilities are clearly apportioned among managers, and that staff are aware of “what the FSA would regard as desirable behaviour”.

The FSA says it wants to “guard against unnecessary intrusion by the regulator into a firm’s business” by making senior management responsible for risk management and controls within a firm. The FSA has also tried to soothe the City by saying that its requirements should not be onerous because they only reflect good practice: well-managed firms should be doing all this anyway.

But these assurances have received a jaundiced reception in the City. Keith Palmer, head of compliance at Dresdner Kleinwort Wasserstein, wrote in the Financial Services Bulletin: “There can be little doubt that firms face a significant challenge in demonstrating that they are able to meet the new regulatory expectations for senior management….The cost to the industry may be rather more substantial than FSA has suggested in its assessment of cost.”

Lawyers everywhere.

We also found a widely shared concern that the FSA’s approach was encouraging the growth of legalism in the City.

“The FSA’s job is to understand how business is done and regulate in a moderating way. This can’t be done with a huge rule book.”

Compliance officer

Many practitioners, particularly on the banking side, felt their relationship with the regulator was slipping from a personal to a legalistic footing. The trust that previously existed was ebbing, lawyers increasingly had to be involved, information was less readily shared. One compliance officer noted that lawyers now attended all meetings, even chaired them, including ones that did not involve the FSA. “Non-litigiousness and legal reasonableness are being undermined”, was his comment. Another said: “The environment has become less susceptible to a negotiated settlement.”

In the FSA’s defence, it has to be said that about half the people we sounded out did not find it unnecessarily intrusive and legalistic, or if they did, they thought the fault was not entirely the FSA’s. Legal pressures are growing willy-nilly with the shift to statute-based regulation and the enactment of measures like the Human Rights Act. But there is also legalistic pressure from the City itself, where people are just as keen to cover their backsides as the FSA. And is this all bad? Even if more legalistic, the new regime offers greater certainty about individuals’ rights. “There was a false sense of security under the old regime; there is firmer backing to the new”, said one of the City’s longer-serving hands.
What sort of a body will the FSA be?

The FSA is not just a regulatory body, but an institution with a growing character of its own, and the City is watching closely to see how it shapes up.

Sir Howard Davies, the FSA’s chairman, gets high marks in the City: he is approachable, he says the right things. This seems to guarantee that, no matter how much the FSA may upset people on the way, everything should turn out OK in the end. The same goes for his longer-serving managing directors, Michael Foot, head of supervision, and Phillip Thorpe, head of enforcement (though he will be leaving in mid-2001).

But esteem for the upper echelons does not extend all the way down. Much the most frequent criticism we heard of the FSA concerned the quality of staff at the operating level where people often found them inexperienced, over-cautious, and constantly on the move. One respondent said he found FSA staff “deliberately antagonistic”, coming into his office “determined to show how tough they are and score points”.

This view of the FSA is clearly affecting its working relationships with the City: it makes it harder for firms to build up a rapport and achieve the level of trust that the FSA wants to establish. Moreover, it creates a gulf between intention and practice, between Sir Howard’s reassuring words and what people see on the ground. And with so much of the FSA’s reputation vested in the top man, what happens when Sir Howard moves on, as the City speculates he might when his contract expires in July 2002? (He has described financial regulation as “a worthy activity, if dull at times”.)

To be fair on the FSA, some firms reported good experiences. The compliance officer at a large Continental bank said after the assessment team had been through: “I couldn’t have faulted them”, though he adds: “We worked hard to build a positive relationship.” Others said the position was getting better.

The FSA agrees it has a problem here. Staff turnover is high (15-17 per cent in one or two departments), and FSA pay scales have to compete for talent in the City job markets within the cost constraints imposed by statute. The authority is trying to respond by creating better career structures and seeking feedback from practitioners (though one close observer of the FSA said: “You never give a true report on an occupying army”). It has also introduced a system of bonuses, albeit modest by City standards. But this is clearly a problem that will only be solved with time. In the meantime, the FSA’s Practitioner Panel has written round to City trade associations suggesting that member firms think twice before poaching its staff (though one wonders why the City is so keen to poach FSA staff if it is so ready to complain about them).

Many people we spoke to made comparisons between the FSA and the SEC. The SEC does not pay spectacular salaries either, but it attracts talent because it provides a good career springboard for the ambitious. The comparison is not perfect, however, because the SEC employs mainly
lawyers who tend to advance their careers through revolving doors, whereas the FSA has more of a public sector culture.

Comparisons with Continental regulators put the FSA in a more favourable light because people see some flow of personnel between the FSA and industry, which spreads talent and experience. In Continental countries regulators tend to remain civil servants all their lives, creating more of a gulf.

City and consumer interests. City people still see the FSA very much in terms of the components that went into it: Bank of England, Whitehall, SROs etc., which is not surprising since it is still some way from being fully bedded in. The gossip usually revolves around who is up and who is down. If the FSA takes a flexible approach to some matter, then Bank of England people must be behind it; if the approach is more bureaucratic, then it must be the work of some rule-bound SRO. This speculation irritates the FSA because it wants to be seen as having a character of its own. (For the record, former Bank of England staff only account for about 450 of the FSA’s 2,000 employees, and four of its 17 directors.)

The FSA wants to be seen as having a character of its own

A tricky relationship

The City is wary of opening up to the FSA - and this is putting a strain on the relationship between regulator and regulated. There seem to be three causes:

1. Unfamiliarity: the City does not yet know what sort of an organisation the FSA will be, so it is inclined to be cautious.

2. The FSA has wide enforcement powers, and the City is waiting to see how they will be used.

3. The City was either ignorant of, or unprepared for, the extent of change brought about by the FSA: a new style, a new approach. So it feels deceived by assurances that change would be “manageable”.

The City’s greatest worry is that the consumer protection side of the FSA will end up being dominant because of political pressure to be tough on City miscreants, and some City people seem to take any sign of high-handed behaviour by FSA staff as evidence of a shift in this direction. (Interestingly, the representatives of consumer interests we spoke to had precisely the opposite fear: that the FSA would be soft on consumer protection to avoid upsetting the City.)

Transparency. Compared with the Vatican-like opaqueness of the City’s old-style regulatory regime - when individuals could be secretly blackballed by the Bank of England - anything else must seem crystal clear. But is the FSA as open in its policy-making as a modern regulator should be?

The numbers certainly suggest it is. By the end of April 2001, the FSA had put out 88 consultation papers running to thousands of pages, covering a host of subjects from big policy issues down to minute technical rules. Each paper provokes responses from City institutions, numbering
from a handful to several hundred depending on the hotness of the topic, and is followed up by meetings. The responses are posted on the FSA’s website and summarised in a second paper which is also circulated for the City’s information. In the final stage of the process, the FSA makes its policy decision, and announces it, with its reasons. It is a truly massive paper machine which has already consumed uncountable man-hours - and is still far from over.

But is it worth it? The City’s answer is a weary yes; it could hardly say otherwise. Yet in the back of the City’s mind lurks a suspicion that it may all be a charade. Open, the initial phase certainly is. But once the responses are in, everything vanishes into a black box out of which, a while later, pops the FSA’s decision.

Many people complained to us that their comments seemed to have been ignored, or that the FSA was swayed by the number rather than the quality of the responses. Sour grapes, perhaps. But one capital markets lawyer said: “The FSA goes through the motions of consultation but gives the impression that it doesn’t listen, even though they’re getting a lot of expensive advice for free.” Another respondent said that City management had relapsed into a “wait and see what the final version is” mentality, by which time it is too late. This is obviously not healthy. However the criticism is not altogether fair. We found several instances where the FSA had amended proposals in light of comments from the City (for example, see “Keeping power in check” on p 16).

Could the FSA improve its act in this area and match the SEC practice of holding its deliberations in public? It would certainly reinforce confidence in the consultation process. Open hearings on selected issues are, apparently, being considered.

Benefits of a single regulator

If the FSA is to prove its worth, there must be benefits for the City in having a single regulator: greater simplicity, lower cost, and more appropriate regulation overall.

On the whole, the City is convinced of the advantages, at least on paper, of the single regulator. Almost everyone we spoke to had good things to say about the concept, which is interesting given how controversial it was originally. People see regulation becoming more streamlined, skills and resources better allocated. “The rationale is irrefutable” was a typical comment. But many people qualified their view by adding that it was too soon to judge whether these advantages were actually coming through in practice.

A number of themes emerged

Major financial groups. The larger City institutions, particularly those classified as “major financial groups” (see box) expect to see the greatest benefits, and some already are. If so, a central objective of the new regime is being achieved, though one respondent reminded us: “One stop regulation is not the same as regulatory simplicity: we have the first but not the second.” But, by definition, smaller groups do not share in this benefit, one of several ways the FSA might be said to be a selective blessing.
Loss of diversity. Despite the City’s support for the single regulator concept, there is regret in some quarters about the loss of the diversity that was offered by the previous regime - and it seems to be growing. Some of this may merely be nostalgia for a regime which looks increasingly rose-tinged as it fades from memory. But some is more deeply rooted in fear of what one respondent called “the growth of a mono-culture”. It is certainly the case that some sectors - like insurance (including Lloyd’s which is now regulated by the FSA) and building societies - have suffered a bigger wrench than others from the switch to an integrated regulator.

One size fits all. We also heard criticism of the FSA’s drive for common standards and definitions across sectors, which at times looks like zeal for harmonisation for its own sake. Although some unification of the rules makes sense in an increasingly unified industry, there is still enough of a gap between, say, building societies and international investment banks, or insurance and mortgages to warrant a degree of differentiation. “They’re trying to create coherence where none exists. It’s a one-size-fits-all dogma”, said the director of a trade association. “You can’t regulate NatWest on the same basis as Marc Rich”, was another comment.

Major financial groups

One of the main reasons for creating the FSA was to simplify regulation for financial groups which operate in several markets, e.g. banking, investment and insurance. Instead of having to answer to multiple regulators with all the cost and confusion that can cause, they have a “one-stop shop”.

To do this, the FSA is using the concept of “lead supervision” where one supervisor, usually the person who looks after the parent company, takes the lead in co-ordinating the efforts of the specialist supervisors to develop a single supervisory programme. The lead supervisor also acts as the central point of contact for the group.

The FSA is also running a limited experiment in what it calls “group supervision” with a number of large City firms. Under this approach, all or most of the supervisors of a particular firm are brought together in a single team under one supervisor.

Under the old regime a Continental bank in London might have had five different regulators looking at its UK activities:

- the Personal Investment Authority for private banking and asset management;
- the Investment Management Regulatory Organisation for investment management and private equity operations;
- the Securities and Futures Authority for investment banking;
- the Bank of England for banking activities generally; and
- the home state banking regulator for the bank’s London branch.

The cost to the bank of managing all these regulatory relationships would have been enormous, and there was always the risk of over- and under-lap, usually the former. Moreover, the regulatory structure would not necessarily match the bank’s internal structure.

Now, under the FSA, the bank would have its own regulatory team at the authority with the knowledge and skills to deal with all aspects of the business. In the case of a non-UK bank, the only part that would remain outside would be home state regulation.
The FSA estimates that about 90 per cent of the Handbook will end up being built on common standards and definitions. But much of the harmonisation is driven, not by UK regulation so much as by international standards set in Basel and Brussels.

The other question raised by growing uniformity is whether the same rules should be applied across the board. The issue is particularly acute on the wholesale banking side, which argues that inter-professional business needs a lighter touch than the retail side with its widows and orphans. The FSA has responded by creating a differentiated regime which distinguishes between professionals, intermediaries and retail, and by proposing a new type of “wholesale only” bank which will be more lightly regulated. This restores some of the differentiation that was inherent in the City’s old regime.

**Consistency.** But not everyone we spoke to had concerns about diversity loss. What they wanted from the single regulator was the magic word “consistency”. One bank, for example, said it had received three different definitions from various FSA departments of what constituted a “large exposure”, which was, in its view, “unacceptable” for so important a matter. Several firms also complained that the FSA’s constituent parts (individual SROs, Bank of England etc.) were still “showing through” and that some firms were getting more lenient treatment than others, though consistency will presumably grow once the FSA assumes full powers. Some also commented that the relationship with the regulator now hung on a single link where previously it hung from many, making managing that one relationship much more of a challenge.

A number of our respondents also pointed out, warily, that the UK was still a long way from having a single regulator. The Bank of England’s London Code for non-investment markets like foreign exchange still operates; almost every sector now has its own Code and Ombudsman, and organisations like the Consumers’ Association and the Office of Fair Trading also have a say in the City’s affairs.

So the City is in two minds: it wants consistency, but also special treatment, and the FSA cannot, will not, satisfy both in full. Even so, diversity is one of the City’s great strengths, and any failure to accommodate it adequately at both policy and working levels could be very damaging.

**Is the FSA too powerful?**

The downside of having a single regulator is that you also risk ending up with a monster. The FSA is very powerful; that cannot be denied. The question is whether it is too powerful, too little constrained. We found the City very worried about this.

**Checks and balances.** The parliamentary debate about the FSA’s accountability was long and messy. The result is that the system of checks and balances around the authority has a patchwork look. There is a board with independent directors, a complaints procedure, an independently chaired enforcement committee, three independent panels representing practitioner, consumer and small business interests, and a tribunal run by the Lord Chancellor’s department to hear disputed cases afresh.

Some of the City’s worry focuses on the untidiness. Some of it focuses on specific points, such as the fact that Sir Howard combines the role of chairman and chief executive (does this affect the board’s ability to scrutinise the executive?), the FSA’s immunity from action for damages
(which the predecessor regime also enjoyed) and the fact that it can decline to accept compensation findings and recommendations from the independent panels (but only at its peril).

Keeping power in check

When the FSA first laid out the criteria by which it would authorise individuals, it said it would check whether a person had been involved “in any business practices which appear to the FSA to be deceitful, oppressive or otherwise improper”. The final catch all assessment gave the FSA huge powers of discretion over who could operate in the City, and met with strong resistance. The FSA later said: “We agree that the assessment ... implies an unacceptable subjective judgment and we have removed this from the guidance.”

Another aspect of the FSA’s power is the lack of regulatory competition. Although the existence of competing regulators opens the door to regulatory arbitrage, it also acts as a bit of a check; it has even been known to spark innovation. The FSA faces no internal competition, nor, for that matter, much from abroad. It would be comforting to feel it had to look over its shoulder more.

But none of this satisfactorily explains the City’s concern, which seems to have less to do with the arrangements than with the fact that the FSA is not home-grown, as it were, and therefore not quite “legitimate”. The FSA is a national regulator in the fullest sense, and its accountability is ultimately to Parliament and not, like some of the City’s previous regulators, wholly or partly to the City itself. The earlier SIB regime may have been statute-based, but at least the governor of the Bank of England was involved in appointments to the SIB board. Now even that’s gone.

The City’s voice certainly gets heard in the FSA: five of the 11 non-executive directors come from the finance industry, and the Practitioner Panel can offer advice - and expect a written explanation if it is not accepted. There are also arrangements for consultation and feedback. But that is flimsy stuff to a community with a strong history of self-regulation, and a mistrust of statutory bodies. “Everyone accepts that accountability to practitioners has gone with the new legislation. But how much regard will the FSA have to practitioner input?” asked a trade association official.

The FSA argues that it is more fully and explicitly accountable than any of the predecessor regimes. It may even be too constrained: could it move fast enough against the next Maxwell? But the accountability issue may not be an area capable of sustaining much rational argument. The statute is on the books, and the City’s desire for more direct accountability looks vain. But the arrangements grate, and will continue to provide useful ammunition for the FSA’s critics until/unless the City is satisfied that they really work.

Questions about the FSA's “legitimacy”

"The key issue is the fact that the FSA wishes to tell the market how to behave, whereas we in the front line are trying to respond to the wishes of the market. It is inevitable that there will be a clash of cultures. But since the FSA are both considerably bigger than us and have the backing of the law they are more likely to win!"

Company chief executive
Cost

The Financial Services and Markets Act requires the FSA to have regard to the cost of the rules it makes. But this does not appear to have put a brake on costs. Rather the opposite. The growing cost of FSA regulation is a big City moan.

However we found many aspects to cost: direct costs, indirect costs, transition costs, start-up costs and on-going costs, each showing different trends, some potentially worrying, but some encouraging, too.

**Direct costs.** The direct costs of running the FSA are rising, but less than the rate of inflation. The forecast outturn for the year 2000/1 of £158m is up 2.1 per cent on the previous year (though the fact that it fell short of its £162.5m budget is because the FSA was unable to fill all its staff vacancies). The budget of £164m for the current year is up 0.9 per cent on the previous year’s budget.

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<th>2001/02 Budget</th>
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<th>2000/01 Budget</th>
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<td>158.0</td>
<td>162.5</td>
<td>154.7</td>
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Source: FSA

(See Appendix II for a budget breakdown by function and cost type)

The FSA says that the cost of running the unitary regulator is less than the sum of all the previous regulators, and that it has a small budget by world standards. Its £160m budget is smaller than Canada’s and less than one tenth that of the US regulatory machine. The City accepts this. The Practitioner Panel recently said it was “satisfied that costs are being carefully controlled”. But the authority’s staffing problems will continue to exert upward pressure on salaries. (A recent vacancy for a managing director was advertised at £270,000, though filled by someone reportedly earning more than £1m a year.) Interestingly, several firms and trade associations told us they would be willing to pay more to the FSA to up the quality of its staff; the Building Societies Association has already offered to do so.

The FSA’s costs are to be met by a system of fees charged to practitioners, set according to the size of the business and the number of “blocks” in which a firm is active. So the more wide-ranging the business, the higher a firm’s fees. The reception for this approach has been generally positive, though for smaller firms the block fee system is a (small) disincentive to diversification.

**Indirect costs.** But the cost of running the regulatory apparatus is only one part of the story, the other being the cost borne by the City itself. In theory, the move to a single regulator should reduce the City’s regulatory costs: instead of having to deal with a different regulator for each activity, banks now only have to deal with one. But in practice banks are having to build up expensive compliance systems to meet the FSA’s requirements whose cost, in many cases, more than offsets any savings from simplification. The great majority of the firms we consulted
said that their compliance costs were growing fast: “soaring” was a word often used. A typical investment bank now employs about ten compliance personnel for every 1,000 staff, and management spends a good deal of its time on compliance matters, much of it very humdrum. The FSA’s tight budget has not reduced overall regulatory costs, but arguably only shifted them on to the City.

The FSA would like the City to see money spent on compliance as an investment in good practice, and as a way of keeping risks (and therefore costs) under control. But this message does not cut much ice: the City does not view regulator-mandated controls as an investment. “A lot of what we do is simply double checking that we comply with the rules”, said the head of compliance at one of the new e-banks. However it should be stressed that a (small) number of firms said that their regulatory costs had gone down. Liffe, for example, will be paying lower fees to the FSA.

Smaller firms. Concern about regulatory cost increases as you go down the scale: smaller firms find it a heavier burden than larger ones, which suggests that regulation is tilting the field in favour of the big boys. Even relatively small stockbrokers now find they need full-time compliance staff. One private client stockbroker we spoke to put his compliance costs at £1m a year, and has joined the spreading practice of itemising a regulatory charge on his contract notes (which is probably quite a healthy development, actually).

Concern about the unequal impact of regulatory cost pre-dates the FSA, but appears to have been sharpened by the tougher requirements of the new regime. The FSA has responded by setting up a small business panel to monitor and advise. Michael Quicke, who jointly chairs the panel, says the FSA has been good at designing the big picture, but poor at gauging the impact at grass roots. He predicts that the weight of rules will reduce the number of small firms in the business, and jack up the minimum size of start-ups.

The start-up issue was highlighted by others, too. Many people commented that regulatory costs were creating barriers against new entrants. Although the practitioners who said this were not totally displeased, this would, if true, be bad for the City. For example, the combination of high start-up costs (consultation with the FSA, obtaining authorisation, statutory capital etc.) and heavy ongoing costs already seems to be deterring people from entering private client stockbroking.

Although the FSA is statutorily bound to produce a cost benefit analysis of its proposed rules, the value of such work is viewed with scepticism because the benefits can easily be exaggerated. “A joke”, “smoke and mirrors” were typical of the comments we heard, though there were some sympathisers who said that CBA was very difficult to do (which may be why the Bank of England, whose supervisory regime is recalled with increasing fondness by many, never did any CBA at all).

Will costs stay this high? Some of these costs come from the need to prepare for the new regulatory regime (training, adapting systems, FSA consultation etc.) and can therefore be viewed as transitional. So the true cost of the new regime will not become clear for a while.

Even so, there is much concern in the City about the ongoing costs of the new regime. Although the FSA says that fewer people will, in total, be regulated than before, and that one-stop regulation should reduce compliance costs, the City sees a process of regulatory creep steadily pushing up the size of the regulatory bill. There will always be pressure for more regulation
from two powerful constituencies who see benefit in it, but do not bear any direct costs: the public and politicians - to say nothing of the Press. Nor is regulation the sole driver behind compliance costs: higher consumer expectations on disclosure and remediation also play a part.

Cost benefit analysis

How rigorously does the FSA measure the costs and benefits of the regulations it imposes on the City? The following example is drawn from the FSA’s consultation paper on money laundering last year.

The FSA estimated that the cost of its anti-money laundering rules in the first year would range from £9m-£34.1m on a narrow definition, or from £17.4m to £51.4m on a wider one. But while costs were measured very precisely, the benefits were stated rather more vaguely. They were put as an unspecified proportion of the 2-5% of City turnover which is said to be lost to fraud each year, according to estimates which are “not uncommon”.

The FSA concluded that “it appears that the likely scale of benefits is of a higher order than the likely scale of costs, and that the proposed Rules would lead to greater levels of general compliance and thus promote consumer confidence”.

The analysis, in this case, consisted of weighing closely measured costs against benefits based on hearsay.

The essential question is whether the FSA is imposing costs over and above what prudent and efficient management would spend anyway. The City says yes, the FSA thinks not. Unfortunately, there is no research to support either side. Regulatory cost is an area which has obvious implications for City competitiveness, and the City is not happy with current trends, or much convinced that they will improve.

Innovation

The FSA is required by the Act to have regard to innovation, vital to the health of the finance sector and the City’s competitiveness. But innovation is difficult because it requires regulatory flexibility. While the FSA shows an awareness of the importance of innovation, we found only lukewarm support for its record to date.

The stories recounted by several entrepreneurs had a similar pattern: the FSA listened, went away and deliberated, came back with a long list of questions, went away again... When approval came through it might be so delayed or hedged about with conditions that the commercial value of the venture was diminished. One e-bank first approached the FSA in the middle of 2000 about a new project and was still awaiting approval eight months later, even though it had made a presentation, answered a list of 75 questions, and held several meetings with FSA staff. “I’d give them a score of one out of ten”, said its compliance officer.

Development of new products and ideas can often be speeded up if entrepreneurs have some way of holding informal consultations with the regulators at an early stage, to get a “take” on how they might respond. This was a strength of the old City regime which seems in danger of being killed off by the
The FSA is sensitive to charges that it stifles innovation

I ask myself what would happen if the FSA had been required (say in the Act) to have no more than 200 pages of rules, covering everything? Whole chunks of the rulebook would have to be excised, and I suspect many of them would not be much missed. Alternative approaches to some general issues would be considered more seriously, notably the roles of competition and disclosure in promoting better standards of customer care and financial soundness.

Former City regulator

The FSA is very sensitive to suggestions that it stifles innovation, and it vigorously denies that the approval process is slow or lawyer-bound. Clearly, there may be reasons why applications are turned down or delayed which the FSA is not at liberty to discuss with organisations like the CSFI. (It declined to comment on individual cases, so we can’t claim to know all the details.) There are other issues, too. For example, the sheer volume of applications for authorisation. In its 1999-2000 year, the FSA approved more than 600 investment firms and over 50 deposit-takers, and applications are up a further 12 per cent this year.

Another reason may be that authorisations involve other jurisdictions, as when City-based firms want to introduce new products and services abroad, which they frequently do. The challenge for the FSA is to make sensible, timely decisions notwithstanding the existence of thorny cross-border issues. When Liffe launched individual futures contracts on a range of international stocks in early 2001, it needed the FSA’s help to obtain trading information from markets in the US and Europe where these stocks were listed. Liffe says the FSA was “generally helpful” in smoothing the path with foreign regulators, particularly the CFTC in the US.

A bland endorsement perhaps. A further consideration is that each innovation requires the FSA to ascend a learning curve, and firms can aid the ascent with the pace and style of their own responses to the FSA’s queries. This seems to be the experience of OM Group which burst on the London scene in 2000 with its bid for the London Stock Exchange, but which has also made other ground-breaking moves in the City (an integrated trading and clearing link, new markets for packaging recovery notes and electricity). OM says it has found the FSA generally supportive of market innovation. Once the authority understood the issues and was confident that OM knew what it was doing, it gave rapid approval. “In general the FSA have been very responsive when we have sprung new ideas on them” said Peter Cox, chief executive of the OM London Exchange.

The disgruntled stories we heard are certainly at odds with the numbers: new banks and firms are being set up in the UK at an unprecedented pace, and a third of Europe’s 50-odd new electronic exchanges have chosen to locate in London. And even if people are not setting up in private client stockbroking any more, there’s plenty of new activity in on-line broking. So while the approval process may not be as fast as applicants would like, it does get there in the end. But it seems that the FSA’s reputation in this area is for taking the line “no you can’t, unless you can show…” rather than the more upbeat “yes, you can do that so long as…”

City competitiveness

The international competitiveness of the UK financial services industry (for which read “The City”) is another factor to which the FSA has to have regard when it carries out its duties. Too
heavy a hand, and a footloose industry might up-sticks for more congenial surroundings. The issue is specially sensitive because the FSA is not the main regulator of any of the large investment banks in the City: they are all foreign.

Despite all the complaints we picked up about compliance costs and the FSA’s intrusive style, we found very little evidence that these have lost London any business. If anything, London retains the strongest appeal among the financial centres in its time zone, and the regulatory climate is undoubtedly a contributory factor. The director of an international trade association said: “The FSA does try to address the market’s concerns. It wouldn’t set out to damage the City.”

A compliance officer’s lot…

The strongest criticisms of the FSA that we received came, not from impatient chief executives, but from compliance officers - which may seem surprising given the key role they play in the new regime. However their lot is not altogether a happy one: they bear the brunt of the FSA’s voluminous consultation exercise, and have to implement the results. No wonder they have strong views.

We found management also quite vocal in its criticism of the FSA, but less well-informed. Many senior executives said they were deeply uninterested in regulation, and annoyed by the growing amount of time and money they had to spend on it. Since the success of the FSA’s regime depends on City management accepting responsibility for compliance in their firms, this may be an area which the FSA could cultivate a little harder.

Where business has gone elsewhere, it tends to be to minor destinations, such as Dublin, Amsterdam and Luxembourg, and usually for tax rather than regulatory reasons. Banks are also booking some types of business in convenience locations such as the Channel Islands while continuing to manage them from London (though the growing number of international regulatory agreements is steadily ironing out technical differences in the rules which make such machinations worthwhile).

The head of compliance at a major US investment bank said: “It would take a lot to make us move, but the FSA must be alive to the dangers.”

This is not to say that some banks have not threatened to quit when patience with the FSA wears thin. The new issue business, for example, is particularly frustrated by the strictness of listing requirements in London, and talks about the competing appeal of Luxembourg (though these rules existed before the FSA). The Futures and Options Association conducted a recent poll of its members which suggested that customers could be deterred from opening accounts with City firms because of burdensome documentation and FSA-driven questioning into what they consider to be private commercial matters.

There is also a concern about regulatory “gold-plating”: the UK practice of implementing EU directives down to the last letter where foreign countries might take a more selective approach. One compliance officer we spoke to said he felt Germany put the competitive position of Frankfurt first, and regulatory implementation second; in London it was the other way round. And while the UK’s emphasis on transparency was a good thing, this was only “up to a point”, he said.
But whatever its faults, the FSA is seen as the most sophisticated and approachable of the European regulators. We heard comments such as: “There’s no one you can talk to in other centres”, and “The FSA has the US character but avoids the worst US excesses”, and “It’s in a different ballpark”. Some respondents attributed the FSA’s appeal specifically to the fact that it is an integrated regulator. The Americans like it because their own regulators are prepared to place trust in the London approach. However, lest the FSA draw too much encouragement from this, we should add a cautionary note from a lawyer who said: “London is strong not necessarily because it has got it right, but because others are still screwing it up.”

There is a further sense in which regulatory reform has been of positive benefit to the City internationally. The FSA is seen as a pioneering institution with a growing international influence. Other countries (e.g. Germany, Ireland, Japan) are following suit, and the FSA is able to shape the debate of financial regulation more widely. In a way, it has become an invisible export.

Conclusions

Were the negative pre-conceptions with which we embarked on this report borne out?

"I was a supporter of the single regulator concept but I’m now increasingly concerned about bureaucratic trends: the sheer inflexibility of the process, the lack of sensitivity. Is there still time to put it right or have we gone too far down the road?"

Official international trade association

Yes, insofar as we found a pervasive mood of discontent in the City with the FSA. The new regulator has caused more disruption than was generally expected, and has yet to deliver many practical benefits. By the same token, though, a lot of this unhappiness may pass as the new regime settles down, and people get used to it. “The City should give the FSA some breathing space”, said one sympathetic observer.

The City is also suffering from the shock of change, witness the confused demands it is making of the FSA for maximum flexibility and maximum certainty, and for special treatment as well as consistency across the board. Here, too, time should sort things out.

But new regimes are always unpopular, and the City’s unhappiness with the FSA may also be evidence of its effectiveness as a regulator.

However there are also deeper concerns.

Can the FSA really deliver light touch regulation?

The City is doubtful. Even discounting the shock of the new, it sees a powerful regulator, a growing bureaucratic machine, and a system in which judgment and flexibility are being smothered by legalism and check-lists. But the FSA is not altogether to blame for this: the City is adding to the problem with its own demands for regulatory certainty. Moreover, there is a misunderstanding here: the FSA never set out to deliver light-touch regulation across the
board, only proportionate regulation, which means that the sort of regulation you get depends on the sort of firm you are, and some firms will inevitably get the heavy sort.

Can this dilemma be resolved? After all, the Takeover Panel thrives as an example of non-statutory regulation.

The gloomiest of several possible conclusions is that the FSA may have embarked, with the best intentions, on mission impossible: you simply cannot deliver flexible regulation with a fist powered by statute; you have to deliver complete certainty.

A brighter one is that the gap between the FSA’s high principles and regulatory certainty could be filled by something other than an ever-thickening Handbook, such as case law and precedent. That would be the classic British way. But many City folk are wary because it would open the door even wider to lawyers. The SEC deals with this problem by issuing “no action” letters which effectively say: “If you do that, we won’t do anything about it.” But the FSA says these letters can themselves become legalistic: it prefers to give individual guidance.

Some of our respondents also felt that an opportunity had been missed to use other ways of influencing City behaviour, such as greater competition and disclosure. We appreciate that this is a difficult area and that the leading exemplars (like New Zealand) are not exactly in the same league as the City. But though the FSA has placed some emphasis on disclosure, it says a regulator should not be in the business of promoting competition.

One constructive suggestion we heard was that the City itself should provide the certainty by setting its own rules of “best practice” with the FSA’s blessing. “They can be the custodians of the principles, we can be the custodians of practice. It’s a tremendous opportunity”, said Anthony Belchambers, chief executive of the Futures and Options Association. The problem is that few people outside the City feel it can be trusted to set adequate standards of its own.

However it is hard to escape the conclusion that light touch regulation is under threat. The pressures are all for more rules and less discretion. The best hope is that, as the FSA gains in confidence, it will develop more sureness of touch which will help preserve flexibility, and build a stronger rapport between regulator and regulated.

Is there value in a single regulator?

Generally, the City thinks yes. Logic favours it, and if it works, the City can see how it might benefit. There is also the prospect that concerns about the FSA’s institutional character - its powers, its legitimacy - will ease once it becomes a full statutory creature at N2.

But there must be longer term questions as to whether a regulatory mono-culture is right for a community as large and diverse as the City (we interviewed no fewer than 10 trade associations for this report, each with its own very clear agenda and territory). Will the FSA be able to
accommodate all its demands, and provide sufficient differentiation? Will it be able to provide the flexibility to cater for the needs of smaller firms, for start-ups, for innovators?

The FSA is certainly trying in this area, but, judging by the frustration we encountered in many quarters, still has some way to go.

**Is the FSA good or bad for City competitiveness?**

The bottom line of this report is whether the FSA is a plus or a minus for the City’s international position. The answer has to be a plus, at least once it is fully up and running. Despite all the worries and the complaints, there is no evidence that the FSA has driven business away: rather the opposite, we spoke to several firms which had chosen to locate themselves in London precisely because of the regulatory appeal. Moreover, the concept of a single regulator is clearly attractive, despite its shortcomings: it is seen as modern, progressive, a pattern for others to follow.

But this is a very fragile area. Unlike the US, which has no real competitors in its time zone, London has nearby alternatives which are only too eager to steal its business. International banks are constantly evaluating the appeal of different locations. A false move by the FSA could cause a lot of damage very quickly; in the longer run, an uncongenial regulatory regime could be fatal.
APPENDIX I

CSFI questionnaire about the FSA

1. Do you observe any benefits from having a single regulator (e.g. simpler compliance)?

2. Do you observe any drawbacks (e.g. over-harmonisation, loss of distinction between wholesale and retail)?

3. Does the new regime provide greater or lesser regulatory certainty than what went before?

4. Is the new regime turning out to be unnecessarily intrusive and legalistic?

5. Is the FSA sufficiently transparent in its policy-making?

6. What is happening to regulatory/compliance costs?

7. How good are the people who work for the FSA?

8. Overall, is the finance sector better off with a single statutory regulator?
## APPENDIX II: Funding the FSA

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<tr>
<th>Mainstream regulatory activity – by function</th>
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<th>2000/1 Budget £m</th>
<th>1999/2000 Actual £m</th>
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<td>106.7</td>
<td>103.3</td>
</tr>
<tr>
<td>Other staff costs (travel, training and recruitment)</td>
<td>10.0</td>
<td>9.2</td>
<td>12.5</td>
<td>9.6</td>
</tr>
<tr>
<td>Accommodation and office services</td>
<td>15.0</td>
<td>15.0</td>
<td>16.7</td>
<td>18.2</td>
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<tr>
<td>Professional fees</td>
<td>12.3</td>
<td>13.8</td>
<td>13.1</td>
<td>11.4</td>
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<td>Depreciation</td>
<td>11.5</td>
<td>10.1</td>
<td>9.0</td>
<td>8.9</td>
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<td>IT costs</td>
<td>9.6</td>
<td>9.1</td>
<td>8.2</td>
<td>8.4</td>
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<td>Printing and publications</td>
<td>3.3</td>
<td>3.1</td>
<td>3.1</td>
<td>3.6</td>
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<tr>
<td>Other</td>
<td>1.2</td>
<td>1.0</td>
<td>2.2</td>
<td>1.0</td>
</tr>
<tr>
<td><strong>Less sundry income</strong></td>
<td><strong>164.0</strong></td>
<td><strong>158.0</strong></td>
<td><strong>162.5</strong></td>
<td><strong>154.7</strong></td>
</tr>
</tbody>
</table>

Source: FSA
David Lascelles is co-director of the CSFI. Most of his earlier career was with the Financial Times where he was New York bureau chief and Banking Editor. He now divides his time between helping to run the CSFI and lecturing at the ISMA Centre, Reading University, Europe’s leading post-graduate institution for investment banking.
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<td>what might happen if EMU precedes economic convergence. By David Lascelles.</td>
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<td>December 1996.</td>
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<td>slip up over the next two to three years. April 1997.</td>
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