

Financial Regulation – Flattering Misconceptions

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In talking to an American audience about the FSA, I obviously need to tread a careful line between a partisan, idealised presentation that seems to dominate descriptions of the FSA right now and a dismissive alternative that suggests the model is irrelevant to an American audience. We have all read (no doubt with varying degrees of bemusement) the recent reports and comments on the contribution of regulation to the financial services industry in the US and the UK. There has been no shortage of such work, mainly coming from US speakers, and Prof Jackson's excellent paper has added another and rather more helpful dimension to the discussion.

The two substantial reports receiving the greatest public attention of late have been the Interim Report of the Committee on Capital Markets published at the end of November (colloquially the Hubbard report, after one of its two co chairmen), and the report on Sustaining New York's and the US's Global Financial Services Leadership (colloquially the Bloomberg:Schumer report, after its co sponsors). There have also been a variety of comments from various distinguished captains of Wall Street from the slopes of Davos.

The Bloomberg:Schumer report sets out several points very clearly. Its main themes are:

- The importance of financial services to the US economy in general (8 per cent GDP, 5 per cent of employment) and to New York in particular (it accounts for 15 per cent of New York City's gross product and more than 10 per cent of jobs there).
- The relative, but not actual, decline in the position of New York as the world's largest capital market centre, and particularly the rise of London, seen as a "threat which needs to be taken seriously". It is important to recognise that this represents a change in relative, not absolute, importance. US financial services continue to flourish: they grew by 5 per cent annually over the last decade in comparison with US GDP growth of 3.2 per cent; in New York they grew by 6.6 per cent against general growth of 3.6 per cent.
- The diagnosis for this relative decline is part of the natural maturing of non US markets, but is largely seen to reflect three influences: "skilled workers; the legal environment; and regulatory balance". The US is diagnosed to have a competitive advantage on the first of these – skilled

workers – but to be significantly disadvantaged in terms of legal system and regulation.

- In particular, UK regulation is found to be preferred because it has a single regulator; a measured approach to enforcement; and an approach based on consultation and discussion. This approach has been more colloquially – but, as I shall discuss in a moment, I believe mistakenly – described as "light touch".

It is, of course, flattering to be held up, however transiently, as the model of good regulation. My reaction to this is however tempered by a recognition that life is rather more complex than these reports and comments suggest: as often occurs, myth and reality diverge. Let me set out two instances where I find the description set out in the various US reports and comments of the UK's regulatory regime difficult to recognise.

Principles based regulation

The first is the description of the UK system of regulation as "principles based" – a remark frequently repeated. Now, it is certainly true that the FSA has principles, governing both the firms and individuals it supervises and its own operations. For the firms and individuals, we have eleven core principles – short enough to be put on a 5" by 3 ¼" card; only 194 words; and the Financial Services and Markets Act which gives the FSA its powers and duties enshrines various principles – consultation, assessment of costs and benefits, the need to have regard to the potential detriment to competition inherent in any regulatory initiative – which we are required to respect (as indeed we do). But the FSA is also an organisation with a very large rule book (8,500 pages of rules and guidance), and could equally – or equally misleadingly – be described as a rule bound regulator. The reality is – and will always be – that the FSA has and will always have a mixture of general principles and particular rules. We are committed to striking a new balance between the two, with greater reliance on general principles, and less reliance on specific rules. This is not easy to do. There is a constant flow of new EU rules (some, but not all, substitutes for existing UK rules); firms and trade associations, even when they are committed in principle to principles rather than rules (and not all are), in practice often show a stubborn attachment to particular rules which the FSA seeks to abolish; and within firms, we often find that the increased reliance on principles which the FSA seeks is supported by chairmen and CEOs, but opposed by compliance officers and lawyers who prefer the certainty of rules.

We are committed to a rebalancing between principles and rules, because we believe it will enable the FSA better to discharge its statutory duties. There are many reasons for this, of which I will mention only two. The first is the impossibility in drawing up specific rules to cover the ever changing range of potential conflicts of interest within a financial services firm. Conflicts of interest are – for all but possibly some of the simplest of

firms – both pervasive and unavoidable. They can be managed, but not eliminated. Any of us who have managed a financial services firm knows the variety of forms in which conflicts arise, and the constant creation of new conflicts: private equity for example gives rise to new conflicts for banks. It is because of this that we have a general principle – FSA principle No 8 – which simply states "A firm must manage conflicts of interest, both between itself and its customers, and between a customer and another client". The second is what I call the protean nature of the financial services market: the restless search for new instruments, new trading strategies, new ways of dividing and managing risk. We in the FSA avoid authorising products – a process which would dampen or even stifle this innovative drive. But we do set out principles which apply to all firms, practices and products: principle No 3 requiring responsible and effective controls and adequate risk management systems; principle No 4 requiring adequate finance; or principle No 5 requiring proper standards of market conduct. Some of these are underpinned by detailed rules: for adequate finance under Basel standards, or rather their translation into EC law; for market conduct by a detailed rule book. But we aim to rely more on the principles, less on the detailed rules. We have, for example, recently replaced 57 pages of rules governing anti money laundering – a particular aspect of principle No 3 on effective controls – with just two pages. We will also be reducing our conduct of business rules, which govern the relationship between firms and their clients in the retail market, by around half – a reduction of some 350 pages. By the end of next year we will have reviewed – and I expect to have reduced substantially – rules which in total account for more than 80 per cent of the administrative costs imposed on firms by regulation.

But, for all the rebalancing we are doing, we will never be simply "principles based".

"Light touch"

The second myth is that the FSA is a "light touch" regulator, with the implication that the attractiveness of the UK's regulatory regime is that it permits practices prohibited elsewhere. In its most extreme form – or its mistranslated form – "light touch" is transcribed into "soft touch".

But in very many respects, the FSA is not "light touch". In some important areas of financial services, for example, we regulate activities which are unregulated in most other countries: hedge fund managers, for example, are subject to a regulatory regime in the UK which has no legal equivalent in the US or any practical equivalent in any EU country (interestingly, hedge funds managed by regulated hedge fund managers in the UK are growing particularly rapidly – more rapidly than those managed from the US; regulation does not necessarily lead to depressed

growth). In other areas, we have deliberately chosen a level of regulation which is more demanding than that adopted in some other countries.

Nor should the FSA's enforcement practices be regarded as light, still less soft, touch. When Citigroup carried out in August 2004 a trade in European sovereign bonds which was widely regarded as a breach of market practice – the MTS trade – the sole European regulator to take action against it was the FSA, which fined Citigroup £13.9 million. Similarly, when Shell withheld from the market information on reserves in 2004, it was the FSA which took action, with a fine of £17 million. By EU (though not US) standards, these were both large fines.

But it is not simply the ability to impose a sizeable fine which makes "light touch" an inappropriate description of the FSA. It is important that we have the flexibility to sanction firms for breach of principles, even when no specific rule may have been broken. The Citigroup fine was for a breach of a principle, as was the more recent fine of £6.3 million against Deutsche Bank for trading in shares while carrying out a book building operation.

For all these reasons – scope of regulation, ability to impose substantial fines, ability to take action against breach of principle, even when no specific rule has been broken – I think it misleading to characterise the FSA as "light touch".

A much more appropriate description is "risk based". We neither seek to avoid all failure of financial firms (an impossible goal, whose pursuit has many undesirable consequences), nor do we approach all firms we regulate in the same manner, but rather devote resources according to the potential impact that a firm might have on our statutory objectives and according to the risk of such impact occurring. For some firms, this results in a dedicated team and a relationship which we characterise as "close and continuous". Less than one per cent of the firms we regulate are subject to this "close and continuous" regime. But for more than 95 per cent of the 29,000 firms we regulate we judge they are so small and consequently present such a small threat to our objectives that in the normal course of business we plan neither to visit nor inspect them, relying instead on statistical analysis and what we call thematic studies.

Making risk-based regulation effective has many aspects. It is a far from easy task. Let me give examples of the practical issues with which we have to deal.

First, there is the problem that, while a non zero failure policy is accepted, and even applauded, ex ante, after the event of a failure there is a general tendency to act as if failure of a financial institution should be equated with failure of the regulatory regime. It is managerially difficult to persuade those within a regulator who are subject to criticism or repeated

enquiry about a financial failure that we believe in a non zero failure policy, and that regulation of financial services – like the business of financial services themselves – is an activity which cannot escape risk. We need both regulators, and those who comment on regulators, to recognise that risks are unavoidable.

Second, there is the problem of effective enforcement among small firms: it clearly makes sense for the FSA to concentrate its enforcement resources – like its other resources – where they will have most impact, and this means that many of our enforcement actions are directed at large firms. But it is also important that small firms do not believe that they can transgress with impunity, on the basis that they are "below the radar screen" – so small that action against any particular one was deemed to be unjustified. Such a policy would reduce the incentive for any small firm to comply with regulations which imposed costs on them; it would cause resentment among compliant firms who observed non compliant competitors carrying on without sanction; and it would encourage regulatory arbitrage, with a tendency for individuals to seek to escape regulatory costs by joining smaller rather than larger firms or networks. So a risk based approach to enforcement requires a more measured and thoughtful approach than one which applies a simple rule of thumb that no firm below a certain size deserves investigation.

Third, there is the constant need to make a risk based approach work in practice, in terms of shifts in FSA resources, or shifts in FSA policies. We have, for example, over a number of years made a substantial shift in the relative resources devoted to bank supervision and supervision of insurance companies, switching resources from the former to the latter in response to our view of the risks in those sectors. In a similar way, we have quite dramatically increased our spend on financial capability – from £3.6 million in 2003/04 to £17.1 million planned for 2007/08 – in response to our view on the wide ranging threats posed by the low level of financial capability in the UK. In terms of processes, we have made changes to reflect changing risk assessments. In our work as a listing authority, for example, we have changed our processes for vetting prospectuses and circulars to concentrate our resources on those which, for reason of size, complexity or other factors, present the highest risk, and which therefore receive a full review from our most experienced staff, whereas lower risk documents receive a less full review by more junior staff. In our response to financial promotions, we have again adjusted our priorities to reflect changing risks. For example, in determining our policy towards the marketing of venture capital trusts, we originally decided not to address these products within our work on financial promotions, but when the way in which they were marketed and the scale of that marketing changed so that we judged that they presented greater risk to our statutory duties we engaged with the industry to improve the way in which they were being advertised. My general point is that a risk based approach has very practical implications for resources and policies.

Often it requires the decision to do nothing, even though we know that some failures will occur; often it requires a concentration of resources on a particular issue or firm. Even if the result is a low level of direct supervision for very many firms, it is not "light touch"; in terms of effectiveness, it is risk based.

I have questioned the description of the FSA as both "principles based" and "light touch". The former is half true; the latter is certainly even less true. Both are misleading. I have set out the reality, which is more complex: a mixture of both principles and rules, with a determined effort – not universally welcomed, though on balance I believe strongly supported – to move towards greater use of principles and to rely less on detailed rules; and an approach which is risk based, and which recognises that we cannot achieve and should not seek to avoid all financial failure. The reality is both more interesting and more productive than the myth.

One final thought on the various US reports. Behind them, and behind some of the UK comments, is an implicit – sometimes explicit – belief that what is good for New York must be bad for London, and vice versa; that we live in a mercantilist world with limited total trade which if one country or capital market centre gains another loses; in short, that we are players in a zero sum game. Can I simply say that I regard this as fundamentally mistaken: London will flourish all the more if New York succeeds – and vice versa; there is enormous shared interest between these two, the two great international capital market centres of the world; in practice there is great co operation between the regulatory authorities in the two centres.

The FSA were particularly pleased to have been able to co operate so effectively last year with the Federal Reserve Bank of New York and the SEC to develop a common policy to eliminate the backlog in credit risk derivatives which was becoming such a systemic problem – a highly effective pincer movement based on the two capital market centres. It is but one example of the recognition that we have of the mutual dependence between London and New York. I think we would all do well to recognise that reality.