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"Regulatory Structures: Integrated Regulators – The U.K. Experience"

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Background Paper by:
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Introduction

Today the Financial Services Authority (FSA) of the United Kingdom is probably the world's largest integrated financial regulator, and can probably also lay claim to having the most diverse remit and most wide ranging powers. However, it may surprise many to learn that the FSA's claim to this position has only been legitimized in the last few months. Whilst the FSA was conceived in 1998 and started to take form shortly thereafter, the final implementation of enabling legislation only occurred on 1 December 2001. In the interim the FSA had been able to establish its physical form and to construct much of the framework integrating its operations. It has also already begun to learn some of the lessons, both good and bad, that come from embarking upon the path to integration.

In understanding the Financial Services Authority as currently constructed it is necessary to understand the political circumstances prevailing in 1998 that gave rise to the decision of the U.K. government to integrate all industry regulators. It is also important to understand the inheritance received by the FSA; specifically, what were the components of the previous regulatory structure that came together under that FSA banner, and what assets and liabilities transferred to the FSA's doorstep. It is also important to understand the legislative framework behind the FSA: a new, comprehensive piece of legislation, the Financial Services and Markets Act (FSMA) was passed in 2000, and it has been seen as equally adventurous in its breadth and aspirations.

The Background to the FSA

Regulation of financial services in the United Kingdom is a relatively recent concept. Whilst supervisory actions have been undertaken in respect of banking and insurance for many years, (respectively by the Bank of England and various government departments) the non-banking financial services sector first saw a regulatory regime only in the late 1980s. That initial legislation (the Financial Services Act of 1986) conceived of a "free market" in regulatory services – with the capacity for a central body (The Securities Investments Board) to oversee a range of self-regulatory organizations.

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Initially these numbered 5, though they merged down to 3 regulatory bodies (the PIA, SFA, IMRO) by the mid-90's.

That first regulatory system had had less than ten years of operation when a new Labour government was elected with a promise of overhauling the regulatory system. The reasons for the government's policy were various, and in no particular order included the following:

- There had been a number of noteworthy financial collapses or scandals in the 1980's (BCCI, Barings, Securities, Pensions misselling, etc.) and there was increasing concern that the existing regulatory bodies had failed to produce regimes that were sufficiently robust, or to produce uniformly high standards, or that they did not have the powers necessary to deal with increasingly adversarial regulated entities.

- The growth of financial services conglomerates and the merging or blurring of lines between financial services sectors (in the U.K. there were no real barriers to banks undertaking securities business, or insurance business, or vice versa) also had lead to many institutions complaining of the complexity and inappropriateness of the regulatory system.

- There were also concerns that the structure of regulation allowed different regulatory solutions in different parts of the marketplace despite the products, sales processes and customers being broadly the same.

- Finally, another key aim of the government was the elimination of the self-regulatory concept. Self-regulation was viewed as self-conflicted and an unacceptable mixing of purposes – that it was difficult to be confident in a body that was both governed by and paid for by the industry, and yet had to police and enforce rules over that same industry.

As in any matter driven in part or whole by political considerations, there were other factors that were less directly connected with the regulatory successes or failures of the past. A prime factor in the new government's thinking was the need to boost investor's confidence in the marketplace. The new government had a clear understanding of the changing demographics in the United Kingdom, and recognized the need to deal with the increasing burden on the state of pension and health care costs, and of the decreasing ability of the Exchequer to fund those services. The policy aim was to place responsibility for provision of those services more directly on individuals. And it was implicit that those individuals would only assume those responsibilities if they felt competent to enter the marketplace for those services, and had confidence in the regulatory structure that was intended to protect their interests. The government was of the view that the existing structure did not generate that confidence.

There was also an unrelated structural factor – in the United Kingdom the policy relating to interest rates had previously been a political decision. The new Chancellor of

the Exchequer wanted to move that decision making out of government and into the Central Bank (the Bank of England), at the same time giving the Bank full independence. The solution he promoted was to give interest rate policy to the Central Bank, but he also removed Bank supervisory matters to a new authority – the FSA.

It should be recognized that the concept of integration in the United Kingdom was by no means a new one – with early amalgamations occurring as the SROs looked for economies of scale and other synergies. However the government's proposals went substantially beyond anything that had been conceived. The new government decided that integration would not be contained to one or other financial sector, but should produce a single body to cover all banking, insurance, and financial services matters.

The New Legislation

To bring all of this to pass, the new government determined to consolidate and reform existing legislation, and the result was the Financial Services Markets Act 2000. It is described as "skeleton" legislation, inasmuch as it provides a series of broad powers to the regulator, but does not seek to write-in the detail (broadly speaking the rules and regulations of the FSA); these are for the FSA to prescribe. This legislation is groundbreaking in a number of ways.

- For the first time in financial services legislation, it states a series of statutory objectives, namely:

- To maintain confidence in the UK's markets. In come countries market confidence would be purely a central bank matter. The FSA's objective of market confidence sits alongside the Bank of England's responsibility for the stability of the system as a whole.

- To promote public understanding of the financial system, which takes the Authority into the provision of information to consumers, and indeed financial literacy programmes. Relatively few other financial regulators undertake that kind of activity.

- To protect consumers, bearing in mind their own responsibilities for their decisions – a relatively familiar objective internationally, though it is rarely accompanied by an explicit *caveat emptor* clause.

- To reduce financial crime – This objective is gaining increasing prominence in the field of financial regulation, particularly since the events of 11 September 2001.

- It states "principles of good regulation," which included requirements for the regulator to be economic and efficient in the use of its resources, statements that the regulator's actions should not detract from the responsibility on senior management of institutions, statements on the desirability of facilitating innovation and maintaining the competitive position of the U.K. markets, and the importance of facilitating competition between authorized persons; and,

- It provides an unprecedented set of broad powers to allow the FSA to authorize firms and approve individuals, to make rules and issue guidance, to gather information, to conduct investigations, to seek redress, to fine, publicly censure and prosecute firms and to levy fees.

In sum, the FSA received powers to legislate and tax in its own right. These significant and important powers have however been surrounded by a broad spectrum of accountability requirements, and this will be discussed further below.

The Immediate Practical Consequences

In practical terms the FSA inherited the remit of 10 existing regulatory bodies and responsibility for a range of financial activities that had been previously unregulated, including mortgages, some aspects of insurance business, long-term care products, and a host of smaller functions. It also inherited more than 2,000 staff and around 250,000 registered individuals and more than 10,000 licensed institutions. These included firms ranging in size from the largest multinational financial conglomerates, through to small one or two-person financial advisors. The FSA needed to find a way to regulate this enormously diverse population, with that diversity not only evidenced in size and

profitability but also in competence, track record and integrity, and in services and products, customer type and focus.

In inheriting the preceding ten organizations the FSA also inherited ten different ways to regulate. These ranged from traditional bank supervisory and advisory approaches through to enforcement dominated securities regulatory efforts. Some of the regulators had previously focused only on institutions, some had focused on individuals and management, others had only concerned themselves with the marketplace or the product. If that were not sufficiently daunting, all those who were being regulated or supervised had their own views on how this job should be done, and the public, press, and politicians had views too.

Providing a Unifying Model

As the various components of the FSA came together, literally, in one building, work progressed on establishing a framework for regulating once the FSA obtained its full powers. In the interim, the catch cry was "business as usual" – meaning that the various "old" regulators attempted, as far as possible, to do the jobs they had been doing, albeit it a new venue, and with different reporting lines and different resources. The new regulatory structure drew upon a familiar trend amongst regulators to develop a risk-based operating model. Many of the regulators coming to the FSA had had such models for a number of years. The main premise of these models, and indeed the model eventually adopted by the FSA, is that regulators have to recognize they work with finite resources and yet often are presented with an infinite number of possible calls upon those resources. Given the huge and complex task the FSA was to face, it was also important for the new model to provide the following *internal* results:

- A transparent and usable design for prioritizing issues and allocating resources;

- An ability to clearly define issues and desired outcomes and to measure the effectiveness of any regulatory actions; and

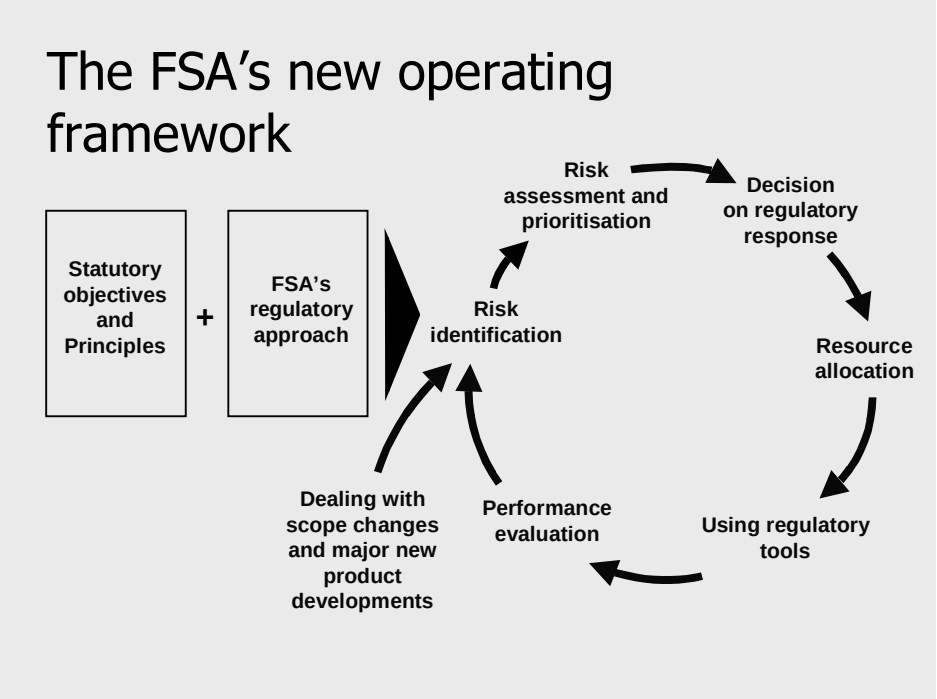
- A means of liberating staff to be risk identifiers and problem solvers, and not just compliance checkers ("box tickers").

And *externally* the FSA also needed an operating model that above all else would allow it to defend its use of resources.

In undertaking the design work, there was an early realization that all FSA actions needed to be capable of being justified as in pursuit of its statutory objectives. At the same time the model needed to recognize that not all firms, individuals, products, services or customers are alike and the FSA would need a basis for recognizing the similarities and the distinctions, and it would need a means of assessing the consequences of using its resources differentially given those similarities and distinctions. Finally, the

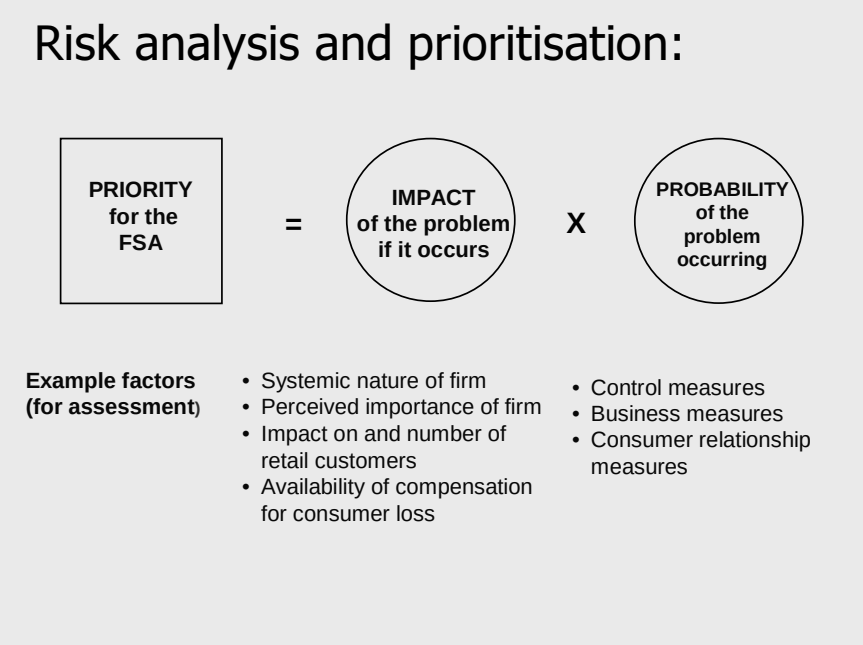
model would need to provide a risk-based regime that allowed for easy internal and external audit.

As it transpired, the provision of statutory objectives and the "principles of good regulation" mentioned above gave an obvious starting point for constructing this model. The FSA had to provide some interpretation to these objectives – they are not ranked or quantified in any way in the legislation. And there was also a clear need for any model to be dynamic; to recognize that the success of particular interventions by the regulator would influence the use of resources in the future, that the world would change and a risk today would be overtaken by new risks tomorrow, and that there would be outside influences, whether political or market-driven that might require rethinking any longer-term plans. With all of that in mind, the model chosen is nevertheless a relatively simple structure.



Risk Analysis and Prioritization

At the heart of this model is the need to be able to analyze risks and to determine which risks receive priority. This too turned out to be a relatively simple equation in theory, though the practice is significantly harder to achieve. The simple theory is that a risk priority for the FSA will be the outcome of measuring its impact and its probability.



If a risk is likely to have a low impact but there is a low, medium or even high probability that it will occur, that may produce a low prioritization for the FSA. Conversely a risk likely to have a high impact and having a high probability will inevitably see the FSA devoting resources to it. There is also the need to convert this risk analysis into some useable set of regulatory actions (or "tools" in FSA jargon) and the FSA took a leaf out of the book of its predecessor regulators by rating institutions (which are the primary regulated entities in the U.K. model) from high impact to low impact – there are four categories, A to D, with D being the lowest impact. This categorization then allowed the FSA to provide a broad initial allocation of resource, with A category firms receiving most attention, and D category firms receiving little or no supervisory or regulatory oversight.

The key to understanding the FSA approach is to recognize that the FSA is only concerned with risks to the FSA's statutory objectives and the perceived impact of any risks (if crystallized) and the probability of the risks crystallizing. This is a brave formulation and will require (will, because the FSA is only now moving to implement this model) a significant change from the way resources have been used in the past.

The FSA's Expected Outcomes

A number of consequences should flow from this risk model. The FSA will need to be able to show that it is giving greater weight to those matters that generate greatest risks and that it is selecting the appropriate tools from amongst its resources and applying them accurately to those risks. The FSA will also need to state in advance what it sees as the key risks going forward and what resources it expects to devote to those risks. And finally, it must state what the expected outcomes will be from applying those resources.

Performance measurement, that is working out whether a regulatory intervention has achieved value, both in terms of money spent and risks averted or damage mitigated, has been a problem for most regulators around the globe. The FSA has had to confront that difficulty and provide realistic performance measures that will allow it to determine whether it has used its resources appropriately, and to allow others to determine whether it is meeting its strategic objectives. An early challenge for the FSA has been in designing credible means of performance measurement and ascertaining desirable outcomes.[2] Another important measure of the FSA's success will be to see whether the risk assessment process does bring the FSA closer to being a proactive and preventative regulator, making interventions that mitigate risks at an early stage or preventing issues becoming problems.

Demands on the Regulated Community and Consumers

The challenges facing the FSA are significant, and will require it to break new ground in a number of directions. However the new legislation also imposes requirements upon both the regulated entities and consumers. As noted earlier, some of these are identified in the statutory objectives and general principles (for instance in the requirement to promote public understanding of the financial system). The FSA has already embarked upon a major campaign of educating consumers in three key respects:

- Firstly, to reinforce the importance of consumers taking responsibility for their own actions and to ensure that they understand the concept of *caveat emptor*.

- To commence a long-term program of improving the understanding of consumers in respect of financial services. This has included education in the classroom and working to promote financial literacy through a wide range of school ages, through to educating in the workplace in respect of particular financial decisions (pensions, health plans, etc); and

- By improving the quality and usability of information provided to consumers, to allow consumers to make more informed decisions about products and markets.

[2] See the FSA's latest publication on this topic, "Our Approach to performance evaluation," January 2002, and the companion document, "Financial Risk Outlook 2002."

Creating an Understanding of the FSA's Remit

The educational efforts described above are important in delivering the FSA's objectives, but they also constitute a useful element of the larger task of managing expectations. There is a danger that in creating such an all-embracing regulator with a wide range of powers, the government has also created an expectation that the FSA will be able to solve all problems and make good all losses.

The FSA has recognized that consumers might easily be misled into thinking that the FSA will prevent fraudsters from doing business, or will reverse losses that the market inflicts and there is the usual tendency in the press and with politicians to look to the regulator to provide a solution whenever there is a market failure. The FSA has therefore seen it as important to lay out clearly what it can do and can't do. A substantial amount of work has gone into educating politicians, the press, and the public more generally into the range or actions the FSA will take. The FSA is also very aware that this is unlikely to dissuade politicians from calling for further FSA action whenever a failure does arise.

Transparency and Accountability

While transparency has been a key goal of the FSA, it is also a requirement of the new legislation, and it takes many forms. The FSA is required to publish a range of annual documents – accounts, a plan, budget, its proposals on fees, and there are also annual reports from its consultative bodies. It is also required to publish proposals for any new rulemaking it intends to make, to publish responses it receives, and to publish its conclusions from those responses. The legislation has also formalized a concept developed by the predecessor regulators by legislating for a "practitioner forum" to provide constant feedback to the FSA on the impact of its actions on the industry it regulates, and a "consumer panel" which provides a similar commentary from the consumer's perspective. Both these bodies have the right to comment on the actions of the FSA and to publish their views, and to require explanations when the FSA chooses to take an action contrary to their views. There is also a requirement for the FSA to hold an annual public meeting and a range of provisions that can require the FSA to appear in front of parliamentary committees, or be the subject of reports at the behest of government departments. In summary, there is a complex structure of accountability arrangements in the legislation, and these have been anticipated and added to by the FSA.

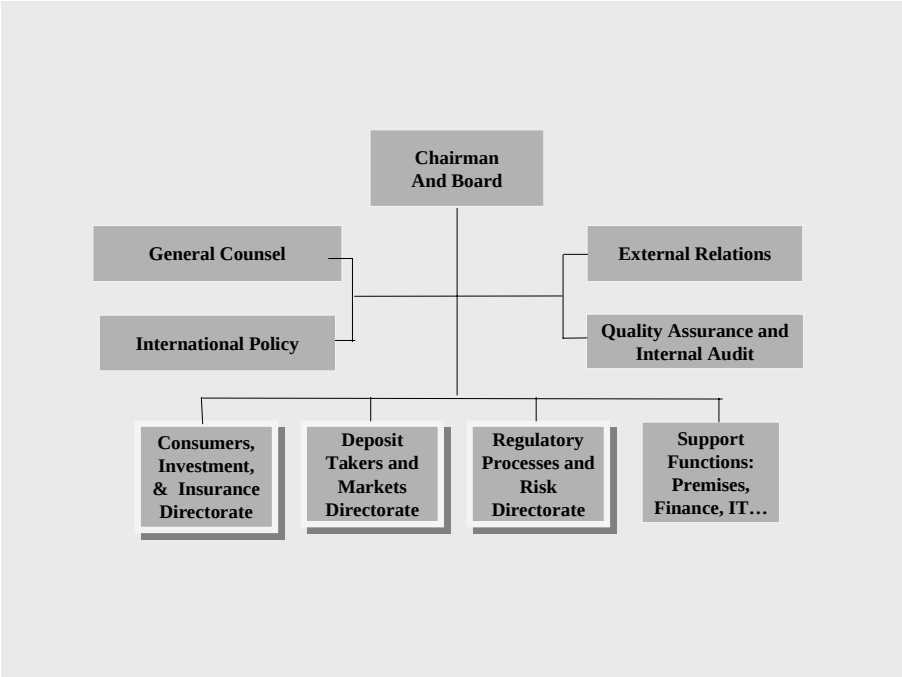
Governance of the FSA

The FSA was established as an independent authority at arm's length from government with a board of executive and non-executive members appointed by the government, with the executive appointed for fixed terms. The practitioner forum and consumer panel mentioned above are appointed by the FSA Board, and other panels have been established by the Board to meet specific needs.[3] A memorandum of understanding

[3] For instance, a Small Business Practitioner Panel has been established to reflect the views of those firms with few employees and relatively modest turnover.

has also been executed which formalizes a tripartite arrangement involving the Bank of England, the FSA, and the Treasury to consider issues of systems stability. In day to day practical terms the executive members of the Board, together with the executive staff of the FSA are responsible for its operation.

To deliver the FSA's program of work a new organizational structure has also been required. This resulted in a highly integrated design which endeavors to bring together common functions into single units. Efforts were made to leave behind the distinctions created by the previous regulators, where they were no longer justified, and so the FSA now has a "Major Financial Groups" Division (within a Deposit Takers and Markets Directorate) which regulates around 50 of the largest financial groups in the U.K., regardless of whether they were previously banks, insurance companies or other institutions.



Practical Issues for the FSA

The unifying effect of the new risk model is yet to be fully experienced, with 2002 being the first year where this will play a significant part in the planning of the FSA. Similarly, the new organizational design is yet to prove itself, having been in place for less than a year. But it is already apparent that if this new model is to be a success, it will need to avoid or overcome some predictable organizational issues. These include:

- "The supertanker syndrome" – With an organization of this span and size, there may be a tendency to doggedly pursue a direction, even when inputs for a change have been made. The capacity to move resource rapidly will be key for the FSA's future ability to respond to new risks.

- "The principal resource in any regulator is people," - this has its pluses and minuses. Amongst the pluses for the FSA is that it has a huge reservoir of experience across a diverse spectrum of financial activities. Amongst the minuses is the inevitable desire of many individuals to avoid change and seek comfort in what they know. The FSA will need to be able to deploy its resources to new areas, without alienating its staff and without losing efficiency.

- "The distraction of the latest calamity." Given the complexity of resource allocation and the importance of keeping to the FSA's statutory objectives, it will be vitally important for the FSA not to be moved off course by whatever is taking the headlines on any particular day. It will require a strong and assertive response to political and public clamor when no action is justified in regulatory terms.

- "Meeting the inevitable challenges." The new legislation has not been fully tested in terms of using its new powers in practice, or through those individuals or institutions who are unhappy with them contesting their application. Undoubtedly this will occur, and it will be important for the FSA to be successful in these early cases to establish confidence in the organization. This may generate a risk of the FSA only picking fights it knows it can win; timidity or conservatism will be unfortunate outcomes for the FSA.

<u>"The Dogs That Didn't Bark"</u>

Many watching the construction of the FSA have raised doubts about the sanity of the exercise. Indeed many within the FSA doubted their own sanity as the work has progressed; and there are probably few within the organization who would have conceived of the FSA in its current form. However it sometimes helps to have seemingly impossible tasks thrust upon you, as you are required to invent solutions and make demands of yourself. Among the many pleasantly surprising outcomes from the establishment phase of the work was the realization that the various regulators and supervisors coming together shared broadly common views of the outcomes they were pursuing. Though they often expressed those views in different languages, and for a few individuals, the process of reaching that understanding was slow and tortured, or did not occur at all.

Another issue that turned out to be less dramatic in practice was in respect of the Prudential versus "Conduct of Business" distinction. For many this distinction – as institutionalized in the Australian regulatory reforms – was seen as likely to be the downfall of the FSA. While there are still some outside and inside the FSA who have not reconciled these two apparently separate regulatory mantras, a hard-nosed analysis of the approaches involved reveals few real differences, with substantial common ground. That does not mean that everybody is always agreed on the most desirable outcome – but increasingly there is a unity of purpose emerging.

And the backstop argument often heard from those unconvinced of the merits of merging prudential and conduct of business regulators (or bank supervisors and securities regulators) that the former try to prevent failures through working with the institution, whilst the latter seek conclusions involving prosecution or closure and that these two approaches are incompatible – has not proven to be an issue in practice, or when FSA staff have studied scenarios to test possible regulatory outcomes. There may well be occurrences when an institution's failure may threaten the system's stability, but two observations can be made – such occurrences are very rare, and the means of dealing with those rare instances is not elusive – the key is to have a means of assessing the consequences of the different regulatory actions that may be taken, and a decision-making process for ranking the consequences and acting upon the chosen course of action.

And finally, if there is one overriding lesson to be learned from the FSA experience to date, it probably is that if you wish to embark upon the path to integration, it helps when there is no way back!

5 March 2002