



Experience with a large integrated
regulatory authority

The example of the Financial
Services Authority in the UK

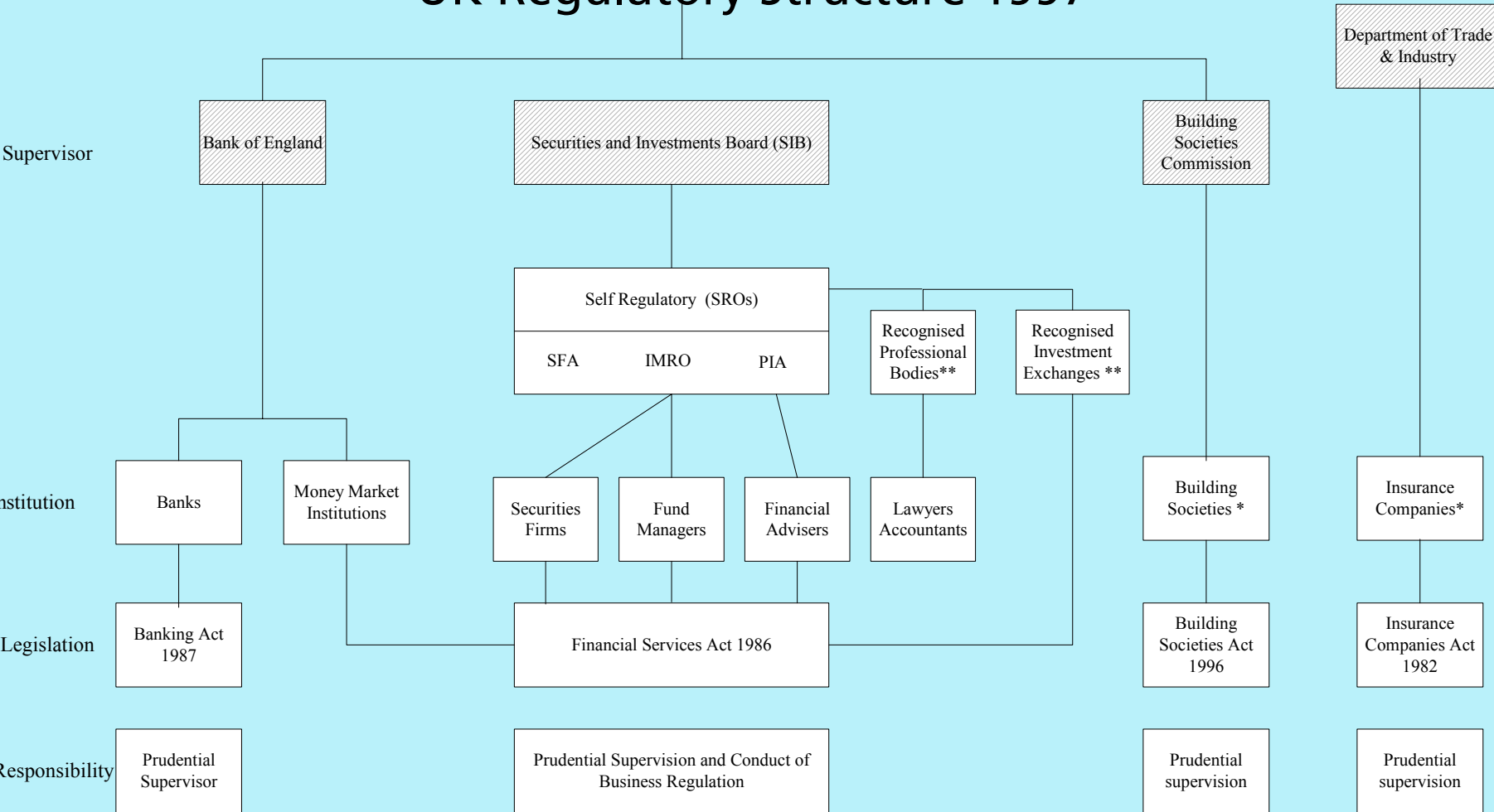
Zurich Financial Services
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Background

UK Regulatory Structure 1997



* Also regulated under the Financial Services Act for their investment business activities

** Includes Recognised Clearing Houses



Insurance regulation - History

- Department of Trade and Industry
- Transfer of regulation from DTI to Treasury
- Responsibility for insurance supervision contracted out by Treasury to FSA with effect from 1 January 1999
- FSA took full responsibility for insurance regulation under FSMA at N2 (1 December 2001)



Banking Regulation

- Bank of England – as central bank since 1979 – following secondary banking crisis
- All supervisory functions transferred to FSA with effect from 1 June 1998
- Transfer covered the Bank's functions as banking supervisor and as supervisor of listed money market institutions
- The existing legislative framework continued to apply until "N2", i.e. 1/12/2001 when FSMA, the new law implementing integrated supervision came into effect.



SROs: Background

- Financial Services Act 1986 – radical new supervision of securities firms, based on “self regulation”
- SROs operated under the Securities and Investment Board (SIB), an umbrella organisation with statutory powers
- 3 SROs:
 - Securities and Futures Authority (SFA)
 - Personal Investment Authority (PIA)
 - Investment Management Regulatory Organisation (IMRO)



The post N2 regime (I)

- The current regulatory regime created by FSMA 2000 under which FSA is the single regulator
- To create the FSA, ten different supervisory agencies/authorities were merged:
 - 1) Securities and Investments Board (SIB)
 - 2) Securities and Futures Authority (SFA)
 - 3) Personal Investment Authority (PIA)
 - 4) Investment Management Regulatory Organisation (IMRO)
 - 5) Banking Supervision Division of the Bank of England

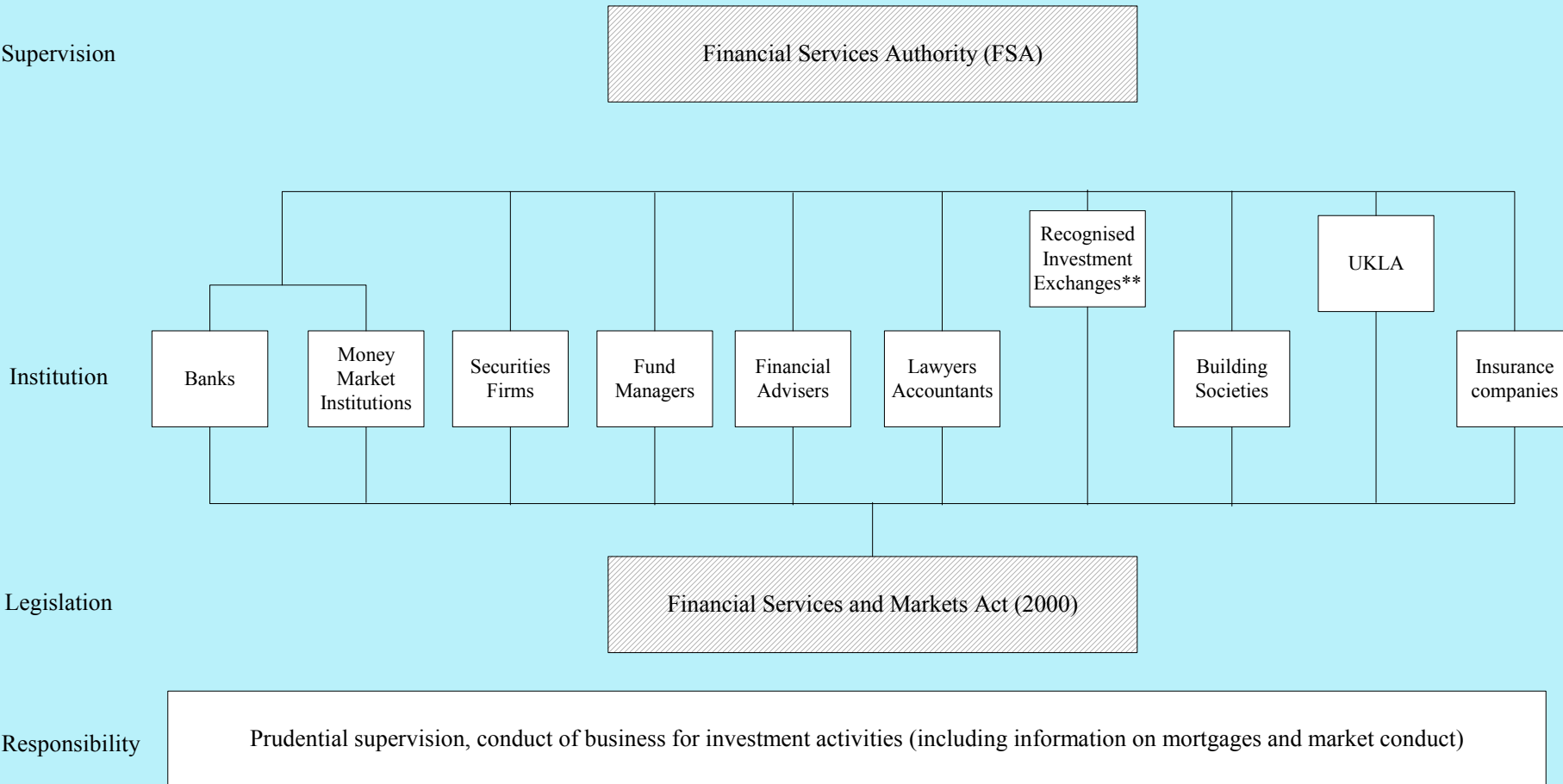


The post N2 Regime (II)

- 6) Register of Friendly Societies
- 7) Building Societies Commission
- 8) Friendly Societies Commission
- 9) Insurance Directorate (HM Treasury)
- 10) London Stock Exchange's function as UK Listing Authority



Current regulatory structure



** Includes Recognised Clearing Houses



Objectives of the FSA

1. **Market confidence** – maintaining confidence in the financial system
2. **Public awareness** – promoting public understanding of the financial system
3. **Consumer protection** – securing appropriate degree of protection for consumers
4. **Reduction of financial crime** – reducing extent to which it is possible for a business carried on by a regulated person to be used for a purpose connected with a financial crime



FSA's principles for businesses – applicable to all firms

1. **Integrity** – a firm must conduct its business with integrity
2. **Skill, care and diligence** – a firm must conduct its business with due skill, care and diligence
3. **Management and control** – a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems
4. **Financial prudence** – a firm must maintain adequate financial resources
5. **Market conduct** – a firm must observe proper standards of market conduct



FSA's principles for businesses – applicable to all firms (II)

6. **Customers' interests** – a firm must pay due regard to the interests of its customers and treat them fairly
7. **Communications with clients** – a firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading
8. **Conflicts of interest** – a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client
9. **Customers: relationships of trust** – a firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement



FSA's principles for businesses – applicable to all firms (III)

10. **Clients' assets** – a firm must arrange adequate protection for clients' assets when it is responsible for them
11. **Relations with regulators** – a firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice

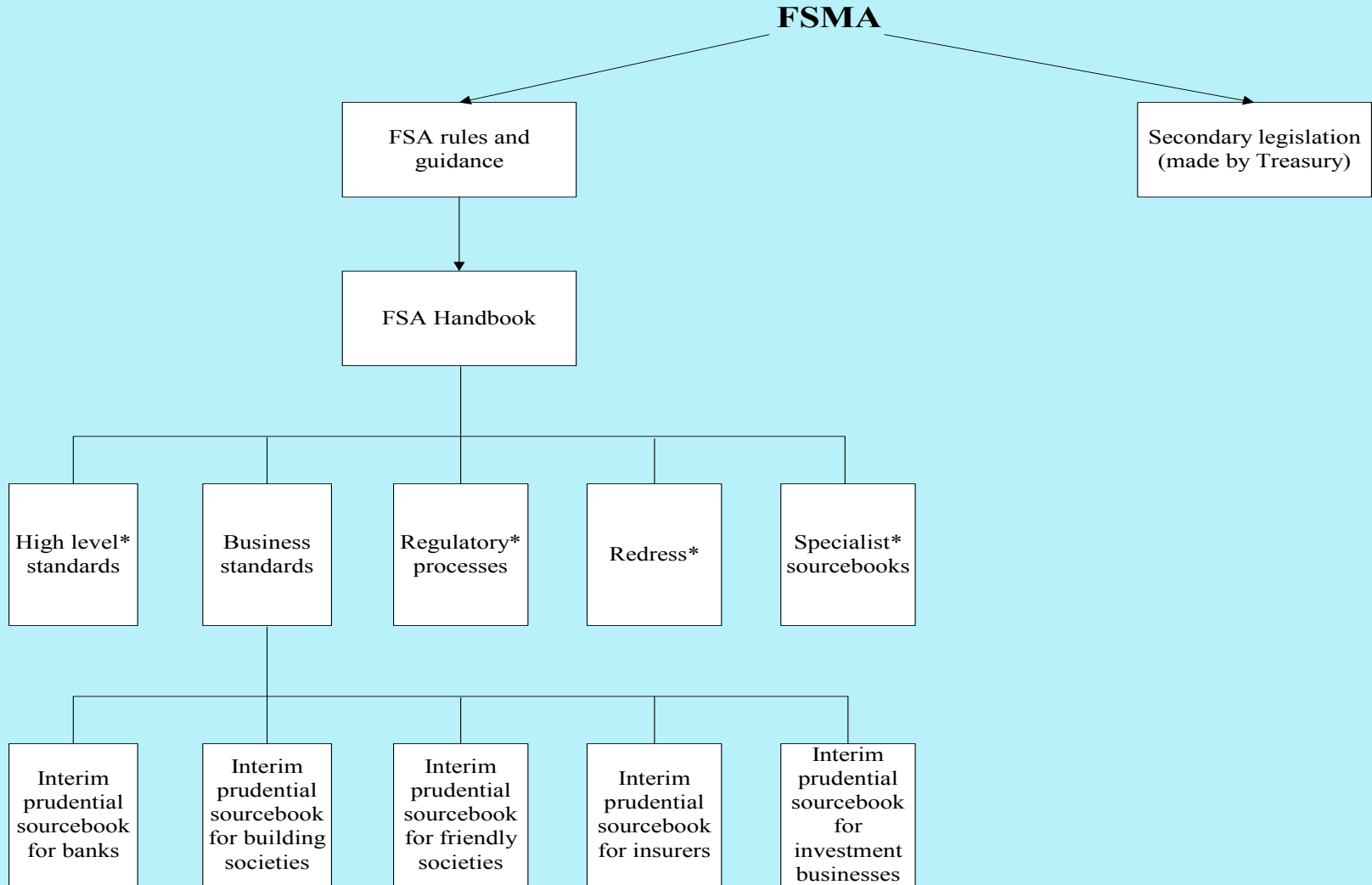


Supervising Individual Firms

- FSA adopts a risk based approach by reference to its statutory objectives
- Supervision involves a mixture of “prudential” and conduct of business – advantageous to combine these two aspects in a single regulator
- Single FSA division supervises the largest 50 firms across all aspects of business (e.g. securities, banking, insurance)
- Other supervision divisions organised by sector



FSMA – Structure of Rules



These high level blocks have not been broken down for purpose of this slide



Integrated Prudential Sourcebook

- FSA's first set of rules were substantively "same as before"
- Intention to move to proper integrated rules over time
- First stage, in 2004, will encompass a full new Prudential regime for insurance companies
- Last stage will be by end of 2006, following the implementation of the revised Basel Accord and related European Union capital adequacy legislation
- In between FSA intend to bring in other provisions, notably liquidity risk and an integrated group regime



Rationale for a single regulator

- Blurring of boundaries between types of financial services products
- Increase in number of institutions that cut across traditional sectoral boundaries (financial conglomerates)
- Economies of scale resulting in a reduction in direct cost of regulation
- Simplification of procedures
- Less confusing for consumers
- Facilitate international co-operation
- Clearer system of accountability
- Reduce likelihood of regulatory 'failures'



Regulation and central banking (I)

Arguments against central bank as banking supervisor

- Possible conflict of interest between roles of monetary policy and banking supervision
- Concentration of power in hands of central bank
- If problems occur (such as collapse of sizeable bank) too much senior management time within the central bank would be diverted into sorting out the problem



Regulation and central banking (II)

Implications of removing supervision from the central bank

- Central banks' core functions include not only monetary policy but also financial stability. Involvement of central banks in payments system oversight, and as lender of last resort, make this intrinsic to central banking.
- Involvement in financial stability led many central banks to establish a banking supervision function.



Regulation and central banking (III)

- Banking supervisory role complements central bank's market intelligence with a detailed knowledge of the strengths and weaknesses of individual banks and therefore the system as a whole.
- UK approach is to leave supervision with FSA and for it, central bank and Government (through HM Treasury) to work together very closely on financial stability/systemic risk issues



Regulation of banks and insurers: harmonisation (I)

- Certain areas easier to harmonise than others – criteria for controller decisions and appropriateness of management on the whole very similar
- Regulation of capital adequacy is more difficult for two reasons:
 - 1) The diversity in the nature of the risks and the way in which parallel systems of regulation have evolved



Regulation of banks and issuers: harmonisation (II)

- 2) Banking and insurance prudential regulation both (to differing degrees) have been the subject of agreements harmonisation at the global level (in the case of banks) or the EU level (in the case of insurers)



Banks and insurers: capital adequacy (I)

- For both insurers and banks, capital adequacy requirements are aimed at ensuring that the relevant bank/insurer has sufficient capital to cover the risks to which it is subject in the course of its business
- Capital adequacy rules for banks are enshrined in Basle Accord (as amended) and EU directives (Banking Consolidation & Capital Adequacy)
- Risk faced by banks does not relate to how much their liabilities will be (these are generally certain), but rather whether their assets will be good to meet those liabilities



Banks and insurers: capital adequacy (II)

- Solvency requirements for insurance companies derived from insurance directives
- Solvency requirements for insurance companies are a function of liabilities rather than assets – this is because the main risk faced by issuers is not non-realisation of assets, but the level of liabilities
- For banks the main risk is that the value of their assets falls to less than the amounts of their liabilities; for insurers it is that their liabilities grow to exceed their assets



FSA in 2003 – How is it going?

- General view is it is working reasonably well (government review planned for 2 years after N2 took place i.e. December 2003)
- But regulated firms report significant practical difficulties in dealing with the regulator: dealing with questions, educating them about the business etc.
- Heavy flow of consultation papers and constant interaction with regulator forces firms to devote more resources to compliance



FSA in 2003 – How is it going? (II)

- Issues faced by FSA include research, short selling and split capital investment trusts i.e. current focus is on retail Financial Services industry
- FSA inherited some problems: e.g. pension mis-selling and problems with insurers; Equitable (a life mutual hit by guaranteed annuities) and Independent (p&c insurer)
- Chairman leaving this summer: some criticism but generally regarded as having done a good job