

## House of Lords Select Committee on Regulators: inquiry into major sectoral and functional regulators

### A submission by the London Investment Banking Association (LIBA)

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#### Summary

This submission explains that LIBA's response to the Committee's Inquiry reflects the Association's work for international, wholesale firms in London. We emphasise that establishing a structure which distinguishes between regulation appropriate for wholesale and retail business is essential – and that FSA has generally risen to this challenge since the Financial Services and Markets Act (FSMA) came into force in December 2001, although this has not been without difficulty in some areas. We also emphasise that compared with its opposite numbers in the great majority of countries, FSA faces arguably unique challenges given London's importance as an international financial centre, and we suggest that it cannot be assumed that FSA will maintain the successes achieved so far: much will rest on the approach adopted for implementing EU directives and the extent to which the move to more principles-based regulation – which, in principle, LIBA Members support – will be accompanied by safeguards of the kind that firms have been seeking. For the wholesale firms that LIBA represents, the debate on these issues has only just begun.

#### A. Introduction and overview

1. LIBA is the principal trade body in the United Kingdom for investment banking firms, including the major international investment banks which base their European and other international operations in London. A list of the Association's Members is attached.
2. This submission seeks to answer the questions raised by the Select Committee on the basis of what we have learned from our work on our Members' behalf with the Financial Services Authority. At the outset, we should stress that given our Members' "wholesale" business – essentially the provision of capital markets financial services for and trading with other businesses – we mainly cover the work of FSA's Capital Markets Sector team, the Wholesale & Institutional Markets Unit and the Enforcement and Strategy & Risk Divisions: we have little direct experience of FSA's work on behalf of "retail" consumers, or with firms whose business is primarily consumer-focused.
3. A number of the sectoral regulators covered in the Committee's Inquiry are primarily concerned with price competition within the sectors that they regulate. FSA, however, has been given different "regulatory objectives" by the FSMA, namely maintaining market confidence; promoting public understanding of the financial system; securing the appropriate degree of protection for consumers; and fighting financial crime. Meeting these objectives presents major challenges and, unlike its

opposite numbers in other jurisdictions, FSA has the responsibility of regulating the major global firms whose wholesale business here makes London the world's leading international financial centre as well as those firms whose business is primarily with retail customers. These markets are very different and it is essential that recognition of this is embedded in the way in which FSA proceeds. Wholesale and retail business must each be regulated appropriately. Given the importance of wholesale business to London, establishing arrangements that *reliably* maintain that appropriate emphasis – while all the time meeting the range of consumer issues that FSA also has to address – presents unique demands, the extent of which may not have been fully appreciated when the previous regulators were brought together as FSMA was enacted. The wide range of existing demands should be taken into account in any further debates about broadening further the scope of regulation under the FSMA.

4. FSA has wide-ranging powers over the firms and individuals within the industry that it regulates, including the power to levy unlimited fines when rules are contravened. FSA's principal tasks – as far as our Members' business is concerned – are making the *regulatory requirements* which apply to their business (FSA's policy work), and *supervising* firms' business in the light of the requirements to which they are subject (supervision and enforcement). Overall, our Members believe that FSA is increasingly successful at addressing the challenges that it has to meet. That is not to say, though, that there have not been difficulties in the past, or that there are not areas where FSA needs to continue to improve its approach. Moreover, and as explained below, there are important challenges for FSA in the future.
5. The Committee may wish to note that the biennial survey of firms' views on FSMA regulation, conducted by the Practitioner Panel, provides a valuable insight into firms' experiences: helpfully, the survey findings distinguish firms according to the kinds of business that they undertake. The most recent survey was published on 30<sup>th</sup> November 2006.

## **B. Regulators' working methods and their effectiveness (Questions 1-7)**

6. As noted, FSA's statutory remit is established in the FSMA. In addition to its four regulatory objectives, the FSA is governed by "seven principles of good regulation" set down in Section 2(3): in carrying out its general functions, these are to be given equal weight to the four regulatory objectives. In our experience FSA does not "work beyond" its statutory remit but, as drafted, the objectives and principles of good regulation give FSA considerable discretion which makes it particularly important that the mechanisms in the legislation to establish accountability function well. On policy making, particularly important is the requirement to consult and to conduct cost benefit analyses when new rules are being considered; on supervising firms and enforcement, the principal formal check in the legislation is the requirement that decisions on the imposition of penalties should not be made by those responsible for investigating the issues (and, ultimately, if penalties are imposed, the assessment of FSA decisions by the Financial Services and Markets Tribunal if a firm or individual appeals). FSA is seeking to move to a more principles-based regulation regime (MPBR), and this could well raise new accountability issues. For information, LIBA's interim paper on the implications of MPBR for our Members is enclosed as an Appendix.
7. FSA is largely financed by the firms that it regulates and this system is generally supported by our Members, although there is a growing question about how much of FSA's increasing expenditure on consumer education should continue to be borne by firms rather than the taxpayer. There are also concerns about aspects of FSA's approach to consulting firms on its fees proposals. FSA's financial year is 1<sup>st</sup> April-31<sup>st</sup> March but, typically, it does not consult on fees until February with the result that in practice there is little dialogue with firms about its plans. Particular issues are FSA's expenditure on I.T., where our Members consider that greater transparency about the purpose of the projects is needed, and the allocation amongst firms of expenditure on retail work.

8. The legislation provides FSA with operational freedom. From the outside it is hard to judge the precise extent to which the FSA might be subject to external pressure day-to-day. Like any organisation in the public domain, the FSA will inevitably be subject to media and political pressures in the wider sense. At the time when FSA was established, and in part because of firms' experience of the predecessor regulators, there were concerns that its policy in particular cases might be unduly affected by these pressures. Questions are still asked about this aspect from time to time: again, any significant move to MPBR may prompt further comment. Overall, however, FSA seems to us to have in practice indeed operated with considerable freedom. This makes it important that the accountability mechanisms work well.
9. In this context, the extent to which EU measures now shape regulatory requirements should be noted. For example, much of the conduct of business rulebook with which firms have to comply at present will be replaced before the end of the year by rules under the Markets in Financial Instruments Directive (MiFID). How this regime will affect FSA's approach over time cannot be predicted with any certainty at this stage since many of the requirements here have still to be confirmed. It is clear however, that FSA's work in influencing the outcome of the regulators' international policy debates will become increasingly important. This is not just a matter of seeking to prevent international initiatives that could be damaging to markets in London. It is also important that FSA should persuade other regulators to confirm their interpretation of rules in a timely way, so that disruption to London firms' cross-border business can be avoided: FSA must give weight to the latter, reflecting its obligations to have regard to the desirability of maintaining the UK's competitive position. (A particular question that may have serious implications for FSA's work will be how it responds to the "Level 3" guidance produced by the EU committees of regulators following the Lamfalussy approach to EC financial services legislation: Level 3 guidance is not binding, but regulators undertake to implement it on a "best endeavours" basis – at issue is how FSA will respond to any guidance produced in a way that does not recognise the demands of the UK markets and whether it will ensure that the procedural requirements in FSMA when rules are made are followed appropriately when deciding whether to introduce rules that follow Level 3 guidance.)
10. The Committee has raised three questions about whether regulators provide value for money. The NAO is currently conducting a Value for Money Review of FSA under Section 12 FSMA. This exercise is the first of its kind with FSA and it is not possible to assess it at this stage. However, it should be acknowledged that FSA has made important changes to its internal structure designed to increase its efficiency and focus – these include establishment of the Wholesale & Institutional Markets and Regulatory Services Units and the separate Strategy & Risk area. FSA has also pressed forward with the risk-based approach to supervision, which our Members welcome. This aims to ensure that resources are allocated according to the FSA's perception of the greatest risks to its statutory objectives. The demands of this work – and, in the future, the demands of MPBR – should not be underestimated, so it is important that in practice resources are sufficient to allow FSA to implement its plans successfully. As part of its approach to consultation with wholesale businesses, FSA has also established the Senior Practitioner and Trade Association Co-ordination Committees.
11. The extent to which efficiency savings can be made through co-operation with other regulators is hard to determine from outside – we have no information, for example, about the success of the work of the Concurrency Working Party system. However, FSA has established important Memoranda of Understanding with many of its opposite numbers overseas, as well as with the Bank of England, Treasury and – in respect of consumer credit business – the OFT. The arrangements with EU regulators in respect of the division of responsibilities between home and host State supervisors will be particularly important for firms from other Member States with branches here: this is discussed further below.
12. As regards whether the FSA has created communications systems which provide for accurate receipt and provision of information, reporting is an essential element of the prudential regime by providing supervisors information on firms' business and compliance with relevant requirements. The FSA make use of both financial information, in the form of statutory accounts, and prudential information,

through dedicated regulatory returns. Recently the content of the regulatory returns has been consulted upon (in accordance with the FSA's responsibilities to consult upon rules and guidance under FSMA). The FSA has also outlined principles of good data collection. The industry had a number of comments in relation to the proposed requirements, some of which were taken on board and some of which were not. But our Members were pleased that the FSA did *not* opt for the full range of possible requirements as outlined in the international guidance on this subject produced by the Committee of European Banking Supervisors. The costs to firms of providing information can hinge on the lead time provided. The FSA usually aims to give firms one year to implement reporting changes. In the case of the recent changes introduced by the Capital Requirements Directive, this has not been possible but the FSA has sought to introduce an interim reporting framework before bringing the full reporting requirements on stream.

13. The Committee's question about whether regulators are sufficiently clear in presenting the reasoning and financial models that underpin their decisions, relates in the FSA's case primarily to the regulator's approach to the supervision of firms. Our discussions with our Members, and the Practitioner Panel's Report referred to above, suggest that the large wholesale firms feel that their dialogue with the FSA has been improving, and there is substantial support for the enhanced risk assessment framework that FSA introduced last year (ARROW2).
14. With regard to enforcement, in the past there was considerable concern about FSA's procedures. The FSA eventually responded by introducing important changes following a wide-ranging consultation. Our impression is that fairness of the process is now not questioned in the way that it had been, but it must be stressed that the substantial shift that FSA is proposing to MPBR will provide a further test of the new arrangements. As far as the success of MPBR is concerned, a central question will be whether firms will be given enough early warning about the possibility of enforcement action to allow for self-correction – and the industry is pressing for additional safeguards on this aspect.
15. *Overall*, for the wholesale business that LIBA's work covers, FSA's regulation has been substantially successful (and we comment further on this in section D below). Given the breadth of its responsibilities, FSA's ability to deliver a regime that has worked well for wholesale business is impressive but should not be taken for granted. However, the impact of the EU framework currently being implemented will pose many challenges. Also, as FSA takes forward MPBR, it will need to be particularly attentive to the need to find the right balance between providing firms with sufficient flexibility on determining how to interpret the way the Principles apply to their particular business whilst, at the same time, providing them with sufficient security about how they are to establish the steps necessary to comply *in practice* with the regulator's expectations. The dialogue with wholesale business on how best to achieve this balance – which would include FSA having to articulate more clearly its approach to enforcement in a MPBR world – is only at an early stage.

### C. Economic regulators and the public interest (Questions 8-11)

16. As summarised already, FSA's responsibilities are established by the regulatory objectives set out in the FSMA: these cover a wider public interest than consumer interests (see point 3 above). The principles of good regulation require FSA to have regard to the desirability of facilitating competition between regulated entities and to the need to minimise the adverse effects on competition that may arise from regulatory requirements, but it is clear that FSA is not a competition regulator as such. (Indeed, the FSMA Chapters on rule-making include separate provisions to ensure competition scrutiny and OFT oversight.)
17. FSA conducts research on the implications for consumers of particular market arrangements or potential rule changes and, in addition, through "theme work" with firms FSA explores particular aspects of industry practice about which it feels that it needs a better understanding or which may give rise to concern. (In addition, for business with *retail* customers, FSA conducts "mystery shopping" exercises to assess business practices on the ground.) FSA also commissions research into the

economic consequences of particular practices within the industry in order to establish whether rule changes should be brought forward: the quality of this work can vary though (and see our comments in section E below).

**D. Competition within domestic industries and the UK economy's international competitiveness (Questions 12-16)**

18. The decisions taken on regulatory policies, standards and market structure by FSA can have a significant impact on the industry's performance (which, in turn, has implications for the wider economy). In recent months reports commissioned in the United States have emphasised the degree to which regulatory policy can have a direct and significant impact on business costs and therefore on location/investment decisions.
19. Establishing and sustaining business confidence in regulatory decisions is fundamental to encouraging long term investment in the UK market. Businesses look for a transparent and rigorous approach to policy making and implementation, with the regulator's decisions reflecting knowledge of the market impact of policy options and of the cost – as well as the benefits – of the alternatives. Regulated firms should consider that a regulator's conclusions – if not always agreed with – are reasonable ones given the regulator's statutory objectives. For FSA, given its retail *and* wholesale responsibilities, these are demanding requirements and, from our Members' perspective, FSA has generally met the challenge. In the future, however, FSA's ability to draw a line between the different kinds of regulation appropriate for wholesale and retail business may be limited under EU Directives, and the kind of security that firms must have about understanding regulatory requirements and implementing them could be undermined if MPBR is not introduced in a way that reflects firms' needs.
20. It cannot be assumed, therefore, that FSA's success so far as a regulator for international wholesale business will be maintained: continuing vigilance will be needed. For example, two current FSA initiatives cause concerns in relation to maintaining the distinction between wholesale and retail business. Some LIBA Members remain uncertain about the extent to which wholesale firms should be taking TCF initiatives even when they neither undertake business with retail customers, nor provide structured products for retail customers: at the least, this frustrates business planning. Second, FSA is currently considering proposals that would involve international business being required to contribute to compensation payments to UK retail consumers and to FSA's financial capability work for the first time, even though EU competitors would not be subject to such requirements. More generally, there are concerns that a MPBR regime could result in firms having to address new requirements that have not been introduced according to the process safeguards established under Part X FSMA (although on this, also see Section E below).
21. The kind of restructuring of markets about which the Committee seeks views (Question 13) is primarily focused on privatisation and thus is not relevant to the FSA's work (although we would note that FSA's decision to proceed to "depolarise" the sale of retail products was a market structure decision).
22. As regards foreign ownership of UK financial services companies, FSA and the Government have always stressed that, provided the authorisation threshold conditions are met, the UK is blind to the nationality of owners – and it is clear that the City, and the UK at large, has benefited substantially from this policy. However, foreign ownership can pose problems if the regulatory system of the acquirer of a UK undertaking could potentially change or undermine the principles upon which regulation in the UK market is based. The fast-track adoption of legislation that has become the Investment Exchanges and Clearing Houses Act was considered to be necessary to address these concerns, as regards key components of the market infrastructure here. Also, although not strictly an ownership issue, it should be noted that, as Directives are implemented, achieving a satisfactory division of responsibility between home and host state supervisors will be essential – particularly for the business in other Member States of the branches of EU firms established in London: it is clearly

important that the conclusions to the current debates in Brussels on this aspect are satisfactory and, in particular, recognise that FSA rules should generally apply to the business of a branch here with clients in other countries (rather than the rules of the home state of the firm of which the branch is a part).

#### **E. Economic regulators' use of Regulatory Impact Assessments (RIAs)**

23. Overall, our experience is that on all of the Committee's questions on RIAs, the FSA sets the standard, internationally and nationally, both in terms of thought leadership and increasingly as regards practical implementation. Although not without difficulties on some particular issues, since its inception the FSA has:
- Increased the resources and seniority of its dedicated economic analysis team;
  - Developed rigorous methodologies and practical policy making tools to support the development of evidence-based regulation. These go beyond the use of regulatory impact assessment and include the use of market and regulatory failure analysis to determine whether or not there is a 'prima-facie' case for regulatory intervention;
  - Increased the degree of senior challenge to policy proposals in the formative stages of the regulatory policy process: a senior FSA committee is tasked with ensuring that a convincing market failure analysis is part of the first stage of the policy process; and
  - Made public commitments to undertake and publish market failure, impact and cost-benefit analyses, and these statements have enabled the industry to hold the FSA to account for its actions.
24. Within the context of what is emerging as an exemplary approach to evidence-based policy making, there are two areas where further improvement could be expected:
- Further work remains to be done to embed the spirit and practice of evidence-based policy making amongst staff in the FSA, notwithstanding our view that the FSA is significantly ahead of all other national regulators in this respect;
  - The FSA's move to MPBR and its use of informal policy tools, such as 'Dear CEO' letters and speeches, creates the potential for FSA policy makers to circumvent the spirit of the FSA's policy making disciplines. We will be discussing this further with the FSA during the course of this year.
25. Finally, the FSA benefits from staff, in key positions, with a strong commitment to evidence-based policy making. It will be important to retain this commitment as postholders change.
26. On this matter, we would refer the Committee to the very helpful summary of the FSA's approach in Sir Callum McCarthy's recent speech "Issues for financial supervisors in Europe – the decade to come". In addition, though, we would note that from firms' perspective a key question for regulators when determining whether to bring forward new initiatives should be the scale of regulatory change that firms are having to deal with at that time: there are times when the volume of work is such that only "must have" initiatives can be managed. The present volume of work in implementing EU Directives is such that FSA should as far as possible hold back from other initiatives – except where those would reduce firms' costs – in order to allow firms to concentrate on the essential changes that they need to make.

**London Investment Banking Association  
February 2007**

**House of Lords Inquiry into the UK Economic Regulators:  
questions raised by the Select Committee**

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**Regulators' working methods and their effectiveness**

1. How do regulators interpret their statutory remit? Do they set themselves aims and objectives that take their work beyond fulfilling their statutory obligations? And, if so, why?  
*See paragraph 6 of LIBA's submission.*
2. Are regulators sufficiently independent from government to allow them full operational freedom of action? To what extent does the method by which they are funded have an impact on the measure of their independence?  
*Paragraphs 7-9.*
3. How can we assess whether regulators provide value for money?
  - (a) Do their internal structures facilitate or hinder them in meeting their objectives with regard to providing value for money?  
*Paragraph 10.*
  - (b) Does the work of the National Audit Office help to ensure that regulators provide value for money?  
*Paragraph 10.*
  - (c) Have regulators sought to make appropriate efficiency savings through co-operation with other regulators, by selecting particular lines of inquiry and/or by other means?  
*Paragraph 11.*
4. Have individual regulators established effective collective working arrangements with both functional and sectoral regulators? Is the current Concurrency Working Party system providing sufficient opportunities for co-operation, communication and co-ordination between sectoral regulators and the Office of Fair Trading and Competition Commission?  
*Paragraph 11.*
5. Have regulators created communications systems with their relevant industry or industries, which provide for accurate receipt and provision of information? Do regulators specify clearly, and with adequate notice, what information they require from companies?  
*Paragraph 6, 10 and 12.*
6. Are regulators sufficiently clear in presenting the reasoning and financial models that underpin their decisions? Are regulated companies given enough early warning before enforcement action to allow for self-correction?  
*Paragraph 13 and 14.*
7. In summary, how successful have the economic regulators been? What changes, if any, could improve their effectiveness?  
*Paragraph 15.*

## **Economic regulators and the public interest**

8. What is the most appropriate definition of the ‘public interest’ in respect of the activities of the economic regulators? Is there a divergence between consumer interests and wider societal concerns encompassed by the term ‘public interest’?

*Paragraph 16.*

9. Have regulators been effective in protecting consumers from firms abusing their dominant positions in markets and restricting practices between firms that reduce competition? Have regulators successfully promoted the ability of consumers to switch firms at reasonable cost and without undue restrictions?

*Paragraph 16.*

10. To what extent should the public interest influence regulators’ decisions on maintaining restrictions on competition? How should regulators ensure that regulatory restrictions on competition are limited and proportionate to the public interest(s) they serve?

*Paragraph 16.*

11. What research have regulators commissioned into the public interest(s) they serve, amongst the industries they regulate and those industries’ customers? What use have they made of any such research?

*Paragraph 17.*

## **Competition within domestic industries and the UK economy’s international competitiveness**

12. What scope do sectoral and functional regulators have to improve economic performance either within specific markets or the wider UK economy?

*Paragraph 18.*

13. Have regulators successfully facilitated the transition from public utility monopolies to effective competition within and between privatised or liberalised utilities? How has the restructuring of markets by regulators led to the development of better competition?

*Paragraph 21.*

14. Is there any evidence to suggest that regulatory activity affects industry investment levels? How can regulators improve market signals and incentivise longer-term investment in regulated markets? How should regulators improve and sustain business confidence in regulatory decisions?

*Paragraph 18.*

15. By international standards, have UK regulators succeeded in promoting the international competitiveness of the UK economy? How do the UK’s institutional and regulatory arrangements to promote competition compare with those of other countries?

*Paragraphs 19-20.*

16. Does foreign ownership of UK companies (particularly within utility markets) present specific and identifiable problems for the domestic regulatory framework?

*Paragraph 22.*

## **Economic regulators’ use of regulatory impact assessments**

17. To what extent have regulators established a Regulatory Impact Assessment process that:

- (a) Is properly resourced and transparent;
- (b) Produces high quality consistent analysis;
- (c) Targets resources at areas of greatest economic risk;

- (d) Provides genuine consultation with stakeholders;
- (e) Requires regulators to explain why non-regulatory options have not been pursued; and
- (f) Is a policy-making tool rather than an explanatory tool (i.e. do regulators produce impact assessments as part of the development of policy and not just to justify it once established)?  
*Paragraph 23-26.*