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21st November 2007

Taiya Smith
Executive Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Ms. Smith:

**Re: Review by the Treasury Department of the Regulatory Structure
Associated with Financial Institutions**

The London Investment Banking Association ('LIBA') is the principal trade association in the United Kingdom for firms active in the investment banking and securities industry and the Association represents the major international investment banks which base their European operations in London.

We appreciate the opportunity to respond to the Treasury Department's request for comment regarding their review of the U.S. regulatory structure for financial institutions. The focus of our response is on question 1.3.4 which considers the possibility of adopting a 'principles-based' approach to regulation, and requests comments on the strengths, weaknesses and feasibility of such an approach. LIBA has been working closely with the UK Financial Services Authority in its goal to introduce a more principles-based approach to regulation in the UK, work which has given us a good understanding of the issues that need to be recognised and addressed. These are summarised in the attachment to this letter and the Treasury Department may find this useful in considering the benefits, challenges and feasibility of a US move to a more principles-based regime.

We are happy at a later date to comment in more detail on these points and to discuss the particular UK solutions to the issues raised, if this might be helpful.

A handwritten signature in black ink, appearing to read 'Jonathan Taylor', is positioned above the printed name and title.

Jonathan Taylor
Director General

Principles-based Regulation: A summary of the challenges and the benefits

What is ‘principles-based’ regulation?

A move to a more ‘principles-based’ regime can mean anything from a small, one or two degree move, through greater generalisation, to a radical replacing of even high-level rules with a simple statement of regulatory purposes, which are then referred to when determining whether a firm’s behaviour has met regulatory standards.

Looked at in this perspective of a continuum that runs from very detailed regulatory requirements up to high-level ones, many regulators do not start from the extreme end of a highly prescriptive regime, and even for the most detailed rules-based regime, firms set out further detail in internal compliance requirements on the actions that must take place to satisfy a regulatory requirement. So a move to a more principles-based regime is likely to consist of altering a balance that already exists between what a regulator determines and what firms determine.

Alternatively, a move to a principles-based regime could involve some element of supplementing, rather than replacing, current rules with statements of overall regulatory intent or purpose that would take the form of binding requirements on firms. The FSA’s Treating Customers Fairly (‘TCF’) initiative sets an example of using a regulatory principle (that firms must treat their customers fairly) as the basis of a regulatory campaign to deliver better outcomes for consumers without, for this purpose, adding to or removing any regulatory rules.

Why ‘principles-based’ regulation? Some of the arguments in favour

The benefits of principles-based regulation relate to *the extent* to which it provides clarity about the overall outcomes on which the regulators are focused, while at the same time allowing the industry flexibility in the delivery of those outcomes.

For firms, a reduction in detailed rules, *depending on how this is managed in practice*, could provide greater commercial flexibility. Almost all high level regulatory principles are consistent with long-term business interests (whereas detailed regulation often is not). The absence of more detailed rules set by a statutory regulator leaves the firm free to build its approach to compliance into medium to long-term business goals.

For example, consumer protection standards set at a detailed level run the risk of ‘crowding out’ legitimate business differentiation on service standards. A detailed rule book can get in the way of competition over the level of service provided to customers because many firms will tend to focus on the specific actions required by the rules rather than considering service standards more broadly (a point which we believe led to the FSA’s TCF project in the face of regulatory frustration that a decade of detailed rule making in the retail sector was apparently not delivering good enough outcomes for retail consumers).

This relates also to a more general point from a public policy perspective: ‘principles-based’ regulation has the potential to alleviate the endemic moral hazard costs of regulation. The moral hazard arises because regulatory requirements ‘crowd out’ firm behaviour that would have happened naturally and shift the burden of responsibility for establishing standards away from the firm to the regulator. The outcome is ‘sub-optimal’ because the regulator knows less about the firm’s business than the firm, leading possibly to a perverse outcome whereby more detailed regulation can increase rather than decrease the potential for regulatory objectives to be undermined.

The challenges of moving to a more principles-based regime

Drafting principles is fairly straightforward. A regulatory policy maker who understands the underlying intent of a set of rules should be able to draft these at some higher-level. Rather, if principles-based regulation is to achieve the objective sought, the challenges that arise are ones to do with:

- ? The need to provide firms with sufficient certainty about the regulator’s expectations for them to determine the kinds of systems and controls that are required;
- ? As part of this, an understanding on the part of both the regulator and the industry of the need for fundamental changes to the approach to supervision, enforcement and compliance. In particular, for regulators, the shift toward a more principles-based approach will be challenging for supervisors and enforcement staff who will need to be able to assess and accept that reasonable firms may adopt different approaches to delivering the same outcomes;
- ? The need to ensure that staff at all levels – within both the supervisors and firms – have sufficient breadth of knowledge and experience to enable sensible discretion to be exercised.

Most importantly, the objectives of a move to principles-based regulation cannot be achieved, without, *in practice*, responsibility for decision-making about how a requirement can be delivered moving from the regulator to firms.

In other words, a regulator is unlikely to deliver the regulatory and economic benefits of a move to a more principles-based regime:

- ? If it has or appears to have a detailed ex-ante or ex-post internal view on what a principle requires, possibly including the compliance arrangements that firms must make; and
- ? If it is or appears to be unwilling to accept that there are alternatives to its view and, as an alternative to ‘black letter rules’, uses other – informal – signalling mechanisms to state its views on what it requires, including establishing precedents through enforcement cases.

Based on our experience, we think it is probable that unless these points are addressed in any move to a more principles-based regime, then, in responding to principles-based regulation, firms are likely to be burdened with the cost of overly conservative compliance driven by the potential (perceived or otherwise) for inconsistent and opaque supervision and enforcement action. More fundamentally, in the medium to

long-term, compliance is likely, gradually, to discern *implicit* 'black letter rules', representing a shift back to a rules-based regime in substance, if not form.

Creating certainty about the approach to enforcement in a principles-based regime is particularly important. Unless firms have confidence that a regulator will take a reasonable approach, those with responsibility for compliance either will seek the security provided by detailed rules, or will adopt an unduly cautious approach to compliance – which may well frustrate legitimate business interests – in order to avoid the risk of being second-guessed at a later stage by a regulator or political interests able to judge a firm's behaviour with the benefit of hindsight. Alleviating firms' concerns is important: if firms *feel* more exposed in a more principles-based regime, they will act in ways that are likely to cut across the benefits of principles-based regulation.

Finally, a further issue for the Treasury in the US context might be how to manage the challenges of delivering more principles-based regulation against a background of different supervisory philosophies across the range of US regulators. This has been less of an issue in the UK with its single regulator model.

**London Investment Banking Association
November 2007**