Financial Services Authority

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International Regulatory Outlook

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Introduction

This is the first edition of a 'new look' International Regulatory Outlook. Our intention is to issue 2-3 editions of this publication each year with the object of informing interested readers about developments in the international policy arena and the FSA's attitudes to these. As you will see, this edition contains three sections:

- A commentary on a topical issue – in this case the FSA's views on the changing regulatory architecture in the EU;
- An update on a number of current key legislative measures; and
- An article describing the work of the global standard setting bodies and how they are responding to recent market developments.

We expect future editions of the IRO to follow a similar format, covering a range of issues of interest on the EU and international policy agendas. We hope that readers will find this publication useful. Please give us any feedback on iro@fsa.gov.uk

This new look IRO will form part of an enhanced communications offering from the FSA on international issues. We aim to supplement it with occasional e-mail newletters on topics of interest, as well as an improved international section of the FSA website where much of the standing data previously contained in the IRO will be found. We will continue to hold industry round tables (together with the Treasury) on international issues and will liaise closely with the major financial services trade associations on our international work.

Taken together we hope these measures will contribute to a greater understanding by the FSA's stakeholders of the international work done by the organisation.

The future evolution of regulation in the EU

Background

The UK strongly supports the creation of a single market in financial services in Europe. We believe that increasing the depth and breadth of European markets will provide consumers with greater choice and will allow firms to benefit from economies of scale and scope. This single market needs to be supported by further development of the existing arrangements for regulatory cooperation in order to ensure that citizens benefit from consistent protection.

However, financial services regulation in member states is rooted in national legislation and is typically directed at national objectives. In the UK for example, the regulation undertaken by the FSA is governed by the UK Financial Services and Markets Act.

Nonetheless there is a growing body of EU-wide financial services legislation. The Financial Services Action Plan introduced over 40 regulatory measures (including 27 directives) intended to promote convergence of wholesale and retail financial markets in Europe.

Ensuring that these EU-wide measures are implemented in a broadly consistent way throughout the EU is a major and important challenge. Financial firms which operate across the EU have a right to expect that the supervision they face will be efficient, joined up and cost effective.

It is also important to recognise the vital role that non-regulatory measures have in promoting convergence. Regulators throughout Europe work together to develop guidance which, while not legally binding, is intended to promote convergence in day to day regulatory practices.

Financial services regulation in the EU is currently coordinated in a series of regulatory networks known as the Lamfalussy committees. These arrangements are quite extensive and complex, but the regulatory core consists of three sectoral 'Level 3 committees' (CEBS for banking, CEIOPS for insurance and CESR for securities). These committees have two broad functions: a) to provide advice to the European Commission on the detail of new financial services legislation; and b) to agree and implement guidance which is intended to promote regulatory convergence, but which is not legally binding.

What is being proposed?

- Although these arrangements were only introduced between 2002 and 2004 their operation has already been the subject of quite extensive review. Questions have been raised about whether they are working effectively and whether the committees have been visibly successful in promoting convergence.
- Whilst most commentators agree that the committees have performed well, many also agree that some change is called for in the ways they operate. Not surprisingly, there is a wide range of views about the form this change might take.
- Some argue for radical changes to the regulatory arrangements in the EU, for example through the creation and uniform implementation of a single rule book for financial services. Others would like to see a range of targeted improvements to the current arrangements since they are broadly seen to be working well. The creation of a 'single EU regulator' is not formally on the agenda at the moment but this idea continues to be the subject of debate and speculation in a number of quarters.

The FSA's view

The FSA believes that the current arrangements, while in need of some improvement, represent a solid basis on which to build. The issues are involved, but our views are broadly as follows:

In assessing regulatory convergence, it is much more important to focus on outcomes than on the details of implementation. Are member states implementing measures and undertaking their supervision in a way which is likely to minimise as far as possible the regulatory burdens on firms and promote convergence of outcomes? The answer to this question may be 'yes' even if the precise detail of implementation varies in some cases.

It follows from this that there is scope for some legitimate variation in supervisory practices in member states, even where there is a common body of regulation. European measures should not seek to prescribe the tools (including enforcement) that supervisors choose to use to ensure that regulation is being complied with.

We believe strongly in the value of collaboration among supervisors and the delegation of supervisory tasks. Colleges and other multilateral arrangements allow supervisors to get a better perspective on group-wide issues, to share information, coordinate their plans, undertake joint work and provide a good basis for sharing supervisory tasks.

The detail of these arrangements needs to be worked out on a case by case, risk based basis. It cannot be done formulaically but done properly it can make a tangible difference to international firms' experience of supervision.

The Lamfalussy committees have done a good job to date but the members need to be more challenging in their approach to one another. We strongly support a process of tough peer review whereby committee members would rigorously scrutinise member states' implementation of directives (on the outcomes focused basis described above) and draw attention publicly to any shortcomings.

We also favour a tougher approach to the adoption of 'Level 3 guidance'. This guidance is intended to promote convergence but is not – and should not become – legally binding. There should therefore be no compulsion about applying the guidance but member states choosing not to sign up to and implement it should be required publicly to explain their reasons for this. We believe that this kind of 'comply or explain' mechanism would act as a powerful discipline.

We therefore believe that CESR, CEBS and CEIOPS have the powers and the legal status which they need to perform the tasks allotted to them. We accept that their decision making could be enhanced by the greater use of qualified majority voting (rather than unanimity) in some areas – but believe that their decisions must remain non binding if the present institutional balance in the EU is to be respected.

Other ideas

There is a wide measure of support for the above ideas which have been consistently promoted by the UK. A meeting of EU finance ministers in December set out a number of other possible areas of the European regulatory framework which could be reviewed. The most important of these, together with the FSA's preliminary views about them, are set out below:

- *Undertaking a review of regulators' powers and their use of these.* It clearly makes sense to understand the range of powers available to regulators in the EU and, in particular, to identify any disparities in these. However we see no case for prescribing how these powers are used and would resist any tendency towards this in EU legislation.

- *Level 3 Committees to submit work programmes to the EU Institutions.* We support any measures which increase transparency in the EU legislative process, but would be concerned if it were suggested that the EU institutions take on a formal role of directing the activities of the level 3 Committees. Regulatory independence of government is a key tenet of most international codes of good regulatory practice.
- *An EU mandate for national supervisors.* We support the greatest possible cooperation between supervisors – indeed our own domestic legislation already requires us to co-operate with authorities with similar functions. But, notwithstanding the general wish for greater convergence and cooperation, financial services regulation is still organised on a national basis. We believe that incorporating requirements to consider financial stability implications in all EU countries in domestic legislation could have extremely wide reaching implications for the balance of responsibilities between "home" and "host" regulators and undermine domestic accountability.
- *Common operational guidelines for the operation of colleges of supervisors.* As noted above we believe colleges of regulators, arranged on a case by case basis, taking account of the risks presented by a financial service group, are an effective way of ensuring greater cooperation and convergence of regulatory outcomes. However, we are concerned that much of the present debate risks confusing the arrangements which would be needed for communication between regulators in times of crisis, with the structures that would be necessary for ongoing, day to day regulation. Whilst crisis management arrangements are, of course, of vital importance, the day to day contact between supervisors is key to avoiding crises in the first place. It would be inappropriate to conflate the two complementary, but separate, sets of arrangements which are needed.

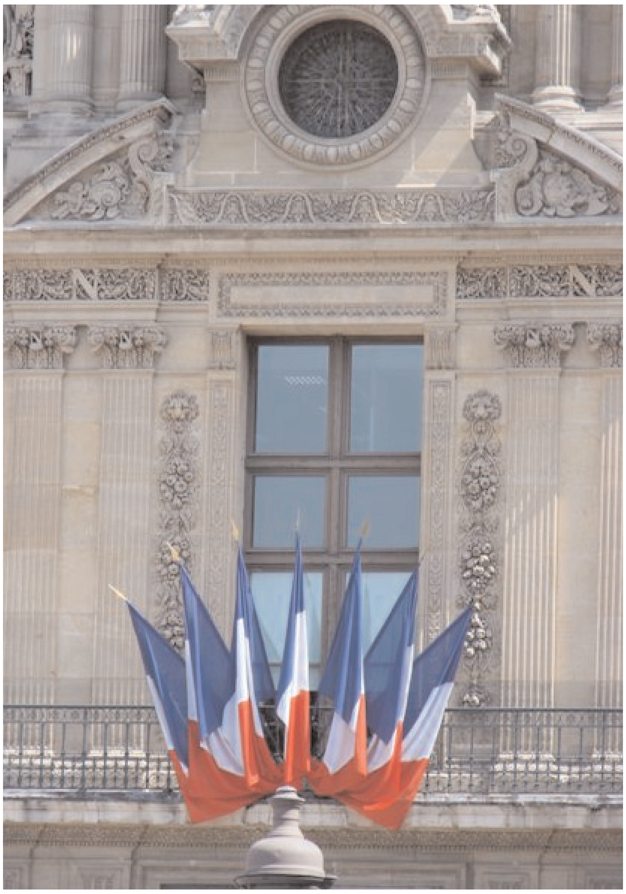
Recent developments

Subsequent to the December ECOFIN meeting the Chancellor of the Exchequer suggested in a letter to his European counterparts the need to formalise in legislation the existing arrangements for so called "colleges" of supervisors.

Whilst there is already extensive practical day to day collaboration between regulators in the supervision of major groups in the form of colleges of supervisors recent events have confirmed the importance of strengthening information flows and collaboration still further. The Chancellor's proposal is a helpful approach which we support.

In our experience colleges of supervisors work best if they are tailored to the institutions they are designed to oversee. We would for example expect different solutions for the supervision of a major European banking group with branches and subsidiaries in most EU countries as compared to a predominantly domestic mutual organisation with one small subsidiary. We would expect a differing level of engagement in a college from regulators depending on the size of the presence of an institution in their country and its systemic importance to their economy. A host supervisor's role in a college may differ depending on whether they are host to a branch or a subsidiary. In any college host supervisors must feel comfortable that they have a level of engagement commensurate with the scale of the entity in their jurisdiction. At the same time, colleges will only be effective decision making bodies if the numbers involved in making the key decisions are manageable. It will be necessary to get this balance right on a case by case basis. Many of the largest global groups for which college arrangements will be appropriate have parents outside the EU. In these cases it is not possible to mandate the creation of colleges through legislation but it is equally important that we build upon the progress made to date in creating and maintaining cooperative arrangements among the relevant supervisors.

The Chancellor's proposal also notes the need to distinguish between colleges for ongoing day to day supervision, and the arrangements which will be needed for financial stability groups in times of crisis.



Interview with Callum McCarthy

You are the UK member of CESR. How do you think it has worked so far?

CESR has done a good job in providing extensive advice to the Commission on the implementing detail of MiFID. This was an all-consuming task for the first three years of CESR's existence. It now needs to demonstrate that it can operate more flexibly on a broad front to promote dialogue and real supervisory convergence.

How do you think the operation of CESR needs to change?

The problem frankly is that the members of CESR are just too diplomatic to one another. While I hope we can remain diplomatic, it is also essential for members to be willing to pose tough challenges to each other when it comes to implementation of directives and the application of Level 3 guidance. That is essential if the industry is to be persuaded that we are serious about delivering convergence and the FSA certainly won't shrink from this kind of tough challenge if it is warranted.

What do you worry about most in the area of EU regulation?

We always need to guard against 'solutions' that are conceptually tidy but also unworkable. These could include excessively formulaic arrangements for supervisory colleges, single EU rule books or high levels of prescription in the use of supervisory tools. The reality is that financial markets are complex and national markets and circumstances differ. We in the FSA are absolutely committed to promoting convergence and we have to work hard with European colleagues to achieve practical day to day solutions which require cooperation and judgement. Only in that way will we get to where we want to be; simplistic 'solutions' are alluring but will ultimately be counter productive.

Update on current legislative matters

Solvency 2

What is it? A measure intended to provide a consistent, risk based basis for setting capital for and and incentivise good risk management in insurance companies throughout the EU.

Where does it stand? The Commission's formal proposal for a framework directive was published in July 2007. CEIOPS is currently working on the detail of the implementing measures. The fourth quantitative impact assessment was launched in April and will run until July.

What does the UK want to achieve? A three pillar approach comparable to that introduced for banking, based on market consistent valuation of assets and liabilities to provide incentives for firms' to adopt effective risk management and mitigation methodologies (including the use of internal models). Responsibility for setting group solvency requirements should ultimately rest with the home country supervisor.

What does the UK want to avoid? We wish to avoid high levels of prescription regarding the harmonisation of supervision and enforcement practices so that we can keep supervision relevant to the great diversity in the insurance market. Furthermore, we do not support one-size-fits-all, formulaic and non-market consistent approaches to the setting of solvency requirements.

What is happening in the next six months? European Parliament and the Council of Ministers are expected to finalise the Directive by the end of 2008. QIS 4 results will be published in November/December.

UCITS

What is it? The UCITS Directive (which stands for Undertakings for Collective Investment in Transferable Securities) was originally agreed in 1985 and updated in 2001. It sets out the specifications for retail collective investment schemes that may be sold throughout the EU/EEA through the use of a passport.

Where does it stand? The European Commission has been consulting for several years on how to refine further the UCITS concept, and it is now finalising its draft Proposal for a targeted legislative amendment to the Directive.

What does the UK want to achieve? Our priority is to achieve the technical changes needed to allow the Directive to fulfil its potential. These changes include improvements in the efficiency of the notification process when passporting funds cross-border, more flexibility in pooling assets and merging funds, and making the management company passport operational, to allow full UCITS management from another Member State.

The package of measures also includes a revamp of the disclosure document known as the Simplified Prospectus, which will be revised and targeted towards the real needs of consumers.

What does the UK want to avoid? The UK would prefer to avoid undue delay in agreement of the package of measures during the negotiation. These measures have been debated for a long while and, given the length of time necessary to agree, transpose and implement European legislation, a delay in the negotiation could prove costly for efficiency improvements which are needed to be operational as soon as possible.

What is happening in the next six months? The negotiations between the Member States and the European parliamentary process will begin at the end of April or the start of May.

Mortgage Credit

What is it? The Commission is seeking to promote competitive and efficient mortgage markets. To achieve this it is examining potential interventions to "facilitate the cross-border supply and funding of mortgage credit, increase the diversity of products, improve consumer confidence and promote consumer mobility".

Where does it stand? A White Paper was published in December 2007. This outlines the potential for a 'policy mix' of actions to address identified barriers. Further study is planned throughout 2008. This includes market analysis of some sectors, and the preparation of quantitative cost-benefit analysis in areas where scope is seen for EU intervention.

What does the UK want to achieve? The removal of barriers to market entry by mortgage lenders and intermediaries, for example inequalities in access to credit reference data. Mortgage lenders should be able to access a range of funding instruments.

What does the UK want to avoid? Legislative intervention, especially on consumer protection, which is likely to be costly, result in measures less well-attuned to national markets, and which will do little to boost integration.

Focus on...The Global Committees

As noted in the first section of this report, a great deal of attention is currently focused on the structure of regulation in the EU. Important though this is, it is necessary in many instances to take a wider, global perspective on financial regulation. Global firms and their regulators tend to face common issues which should be addressed in a consistent way by regulators in all major financial centres. For this reason, the work of the global standard setting bodies is particularly important.

Five main players

The Financial Stability Forum

What is it? A committee made up of finance ministries, central banks and regulators from the major financial centres.

What does it do? The main task of the FSF is to identify vulnerabilities to stability of the global financial system and to ensure that these are addressed. The vulnerabilities it focuses on may be macro economic, macro prudential or regulatory. The FSF is not itself a regulatory body but has the important task of ensuring that risks to stability are identified and addressed by the right global body in a timely way.

The Basel Committee of Banking Supervision (BCBS)

What is it? A committee made up of supervisors and central banks from the major countries charged with setting global standards for internationally active banks.

What does it do? The BCBS was responsible for the first Basel Accord of 1988 which set consistent capital standards for international banks. More recently it was responsible for the second Basel Accord which formed the basis for the Capital Requirements Directive in the EU. The BCBS is currently focusing on the management of liquidity by global institutions.

The International Organisation of Securities Commissions (IOSCO)

What is it? The global standard setting body for securities regulation. Its remit extends to securities markets and intermediaries, exchanges, collective investment schemes and listing issues.

What does it do? IOSCO promotes good practice and sets standards. It has recently produced reports for example on private equity and the valuation of hedge fund portfolios. It also published in October 2004 a code of conduct for credit rating agencies, which is currently being revisited in the light of the agencies' role in rating structured products. It is very active – principally through the creation of a multilateral memorandum of understanding – in improving information flows among securities regulators, including for enforcement purposes.

The Joint Forum

What is it? A committee made up of an equal number of national regulators representatives of the three parent committees: BCBS, IOSCO and IAIS.

What does it do? The main objective is to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates, in order to achieve a consistent cross-sectoral approach on key policy issues and in that way to promote financial stability. In addition, the Joint Forum also responds to direct requests from the Financial Stability Forum to examine cross-sector risks that the FSF is concerned about.

The International Association of Insurance Supervisors (IAIS)

What is it? The international standard-setting body for insurance supervision and regulation.

What does it do? It aims to contribute to improved supervision of the insurance industry on a domestic as well as on an international level in order to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders. It promotes the development of well-regarded insurance markets and thereby contributes to global financial stability.

Current preoccupations

All of the global committees have 'standing' items on their agendas which they have been progressing for some time. IAIS for example is looking at ways of promoting risk based supervision for insurers. IOSCO has a medium term project to improve levels of information exchange among securities regulators and the BCBS has for some time been examining national practices in the regulation of bank liquidity.

But the work of the committees has been given a new urgency by the recent market turbulence. What does the evolution of the 'originate and distribute' model mean for the regulation of banks? Should credit rating agencies be regulated? How should complex and illiquid positions be valued? What changes are needed to the ways in which global firms manage their liquidity? These are all issues with global significance for which global solutions are being sought.

A brief overview of this work is as follows:

- The Financial Stability Forum is playing a key coordinating role, seeking to ensure that the origins of the recent market turbulence are fully understood and regulatory lessons learned. In doing this, it relies heavily on the work of the sectoral committees.
- The BCBS has greatly accelerated its work on liquidity with a view to establishing standards for banks wishing to manage their liquidity on a global, group-wide basis. It is expected to report on this by the summer.
- IOSCO is urgently revisiting the code of conduct for credit rating agencies to determine whether this needs to be updated to take account of the agencies' role in rating structured products. This naturally leads to questions about whether rating agencies should be regulated. A task force in IOSCO is also examining issues around the valuation of opaque or illiquid instruments and whether it is possible to identify improved practices on the buy side when institutional investors purchase structured products.
- IAIS is presently undertaking an important stream of work on developing global standards for the assessment of insurer solvency. The UK presently holds the chair of the Solvency and Actuarial Issues Subcommittee.

What does the UK want to get out of this?

The UK is an active participant in all the major global committees. Financial markets are global in nature and most large global firms have extensive operations in London. It makes sense to aim for consistent global standards which can be readily translated into formal regulation at an EU level (as was the case with the translation of Basel II into the CRD) or at a purely domestic level.

The global standard setting bodies therefore have a key role. But when framing standards or proposals for regulation, the same disciplines need to be observed as those we impose on ourselves in a domestic context. We need to avoid 'knee jerk' solutions which usually lead to bad regulation. We need to be able to identify market failures and to be reasonably satisfied that the cost of regulation (principally to the industry) can be warranted. It is important that issues are addressed in the right place and that duplication is minimised. There is a tendency for global bodies to rush to respond to the same issues in a duplicative way. Coordinating structures like the FSF have an important task in moderating this.

But, subject to all these caveats, it is important that the committees work quickly to identify workable solutions that the industry can buy into. This is essential if their work is to be translated into workable regulation at the national level.

Interview with Hector Sants

How effective are the global committees?

The committees do a pretty good job. If they didn't exist we would have to invent them. For example, the Basel standards on capital and the IOSCO code of conduct on credit rating agencies have made a major contribution to improving the standard of global regulation.

What could they do better?

The committees aren't always nimble enough to respond to crises – the response to the current market turbulence is a good example of that. That may be a feature of their extensive membership and consensus decision-making but they need to be able to respond quickly if individual countries are going to rely on them rather than going it alone. There is also much further to go in terms of having an effective dialogue with industry. This is essential if the committees are to focus on the right things and provide workable solutions to problems that are often formidably difficult.

What do you worry about most?

My main worry is that the committees, which have a potentially key role in helping us address global regulatory issues, become marginalised as a result of being too slow, too bureaucratic and out of touch with how the industry is thinking. I don't think that is a problem at the moment but it is an ever present risk which we need to guard against. Were it to happen, individual regulators would feel obliged to find their own solutions and global regulation could be set back 25 years. In contrast, however, is also the concern that in striving to come up with timely solutions, the committees propose quick fixes which overlook the need for regulation to be practical and cost effective. As matters stand for example, we would take some convincing that a case has been made for regulating credit rating agencies, despite the calls for this from some quarters.

Further information

Contact details

Paul Wright
+44 (0)20 7066 1546
paul.wright@fsa.gov.uk

Contact details

John-Paul Dryden
+44 (0)20 7066 0388
john-paul.dryden@fsa.gov.uk

The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: www.fsa.gov.uk