4 November 2010

Financial Regulation Strategy
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

The CFA Society of the UK (CFA UK) welcomes the opportunity to comment on HM Treasury's consultation on a new approach to financial regulation.

CFA UK represents more than 9,000 investment professionals working across the financial sector. For advocacy purposes, these members are represented by committees that consider proposals relating to professional standards and market practices. The committee's preference is to base responses – in part at least – on member feedback via online questionnaires. The society has not surveyed members in relation to HM Treasury's paper on reforming UK financial regulation due to the extensive number of questions within the paper. As a consequence, the committee's response is brief and addresses only some of the questions posed. However, we make a number of observations that we believe to be important and that we hope will be useful in directing HM Treasury's approach to implementation of the proposals.

Opening remarks

- The aim of the financial system is to ensure that capital is allocated efficiently and that the risk of this capital is priced appropriately
- The events of the last two years have demonstrated that capital was not being allocated efficiently and that the risk of this capital was being mispriced.
- The latest financial crisis should not be surprising as it is the latest in a long series of financial crises; all of these crises share the following three features –
    - Market failure
    - Governance failure
    - Regulatory failure[1]

[1] "Manias, Panics and Crashes" Charles Kindleberger; "A Short History of Financial Euphoria", J.K Galbraith.

CFA UK welcomes and appreciates the open and honest way in which the Treasury has highlighted the weaknesses of the tripartite system. It is imperative that the new framework can learn from history and deliver a more effective regulatory environment which contributes to the efficient allocation of capital and the appropriate pricing of risk.

The new model will need to show that it minimises the financial amnesia of the past[2]. Specifically, the new framework needs to show that the various constituents will communicate effectively; identify problems in the financial system and have the will to respond decisively and quickly to address them; and that its supervision and enforcement brings individuals and firms to account in a way that is a credible deterrent. The new framework does provide some hope in these areas although its structure indicates that it is a response to the causes of the latest crisis instead of addressing the systemic issues that resulted in the crisis.

Research highlights that relying on the tenets of good corporate governance within financial firms will not be sufficient (see Erkens et al[3]) and so an effective regulatory environment is necessary. An effective regulatory environment can contribute to the appropriate pricing of capital and resource allocation.

La Porta et al suggest[4] "these laws and the quality of their enforcement by regulators and courts, are essential elements of corporate governance and finance… in contrast, when the legal system does not protect outside investors, corporate governance and external finance do not work well." On occasion, it may be more beneficial to enforce existing laws and regulations than devise new policies or as La Porta et al state "the strategy for reform is not to create an ideal set of rules and then see how well they can be enforced, but rather to enact the rules that can be enforced within the existing structure."

The interaction of frameworks and regulatory requirements can also help reduce the cost of equity capital. Hail & Leuz (2005) and Leuz (2006) attempt to understand and analyse the complexity of the influences of legal institutions, securities regulation and the level of integration of a nation's capital markets. Emphasising the inherent caveats, they find some empirical support for the claim that firms from countries with more extensive disclosure requirements, stronger securities regulation and stricter enforcement mechanisms (as enabled by a high quality legal infrastructure) have significantly lower cost of equity capital than those that do not rate as highly on these parameters[5]. The table below lists the ten nations with the lowest cost of equity capital derived from the sample cited by Hail & Leuz and how they score with respect to the quality of legal infrastructure (LAW), disclosure (DISREQ) and securities regulation (SECREG).

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[2] Of Laws, Lending, and Limbic Systems William J. Bernstein Financial Analysts Journal, January/February 2010, Vol. 66, No. 1:17-22.

[3] Schumpter: Corporate constitutions; The Economist, October 30th 2010

[4] La Porta, Rafael, Lopez de Silanes, Florencio, Shleifer, Andrei and Vishny, Robert W., "Investor Protection and Corporate Governance" (June 1999). Available at SSRN: http://ssrn.com/abstract=183908 or DOI: 10.2139/ssrn.183908

[5] Department for Business, Innovation and Skills (BIS) Economics Paper No1- BERR's (BIS) role in raising productivity: new evidence ch. 2 http://www.bis.gov.uk/files/file44504.pdf

Country*	Average cost of equity capital (1992 – 2004)	DISREQ**	SECREG**	LAW**
Japan	6.16%	0.75	0.47	0.9
Taiwan	9.87%	0.75	0.64	0.85
Singapore	10.01%	1	0.84	0.86
Germany	10.05%	0.42	0.21	0.92
United States	10.24%	1	0.97	1
France	10.37%	0.75	0.58	0.9
Canada	10.53%	0.92	0.91	1
Italy	10.61%	0.67	0.46	0.83
United Kingdom	10.64%	0.83	0.73	0.86
Malaysia	10.65%	0.92	0.78	0.68

(Source: Hail & Leuz (2005); Note*: sample size differs with country; **based on indices)

<u>General comments</u>

HM Treasury's paper proposes various measures intended to improve the regulatory framework for the UK financial sector. The paper criticises the previous structure and notes that none of the three parties that shared regulatory responsibility had ultimate responsibility for financial stability. The society supports HM Treasury's intention to reduce systemic risk through the introduction of a Financial Policy Committee at the Bank of England to improve macro-prudential regulation of the financial system. The society also supports the establishment of the Prudential Regulation Authority (PRA) as a subsidiary of the Bank of England. It is important to coordinate macro- and micro-prudential regulation and it will be most effective to do so within a single institution.

CFA UK also supports the proposal to separate prudential and conduct of business regulation. These two activities have a different purpose, require different disciplines and may, at times, conflict. The co-location of prudential and conduct of business regulation at the FSA clearly failed. A new approach is warranted.

The society agrees with HM Treasury's proposed approach to locate the regulation of investment management firms at the Consumer Protection and Markets Authority (CPMA), the conduct of business regulator. There is limited systemic risk associated with investment management, which is an agency business rather than an activity where there is significant balance sheet risk. We also support the proposal for the CPMA to have oversight over conduct of business regulation for both the wholesale and retail markets. The PRA should focus exclusively on monitoring and enforcing prudential requirements. Additionally, placing retail conduct regulation in one location should enable the consistent application of regulation across different product types.

Observations

HM Treasury's paper believes the two key failings of the UK's regulatory system at the time of the financial crisis to be regulatory 'underlap' (the failure of responsibility to be clearly identified) and the reliance within financial supervision on 'tick box' compliance.

Communication and Cooperation

CFA UK welcomes the much clearer delineation of responsibilities across the FPC, PRA and CPMA as set out in the consultation paper. As stated previously, we believe it is appropriate for there to be separation between prudential and conduct of business regulation. However, separating these responsibilities across different entities presents a new opportunity for structural failure through absent or ineffective communication and cooperation. The consultation paper states that information gateways will be established between the parties to allow the flow of supervisory information, but there is little additional description of how cooperation and communication may be achieved. Where the process is described, too much faith is put in it. For instance, the final two bullet points in Box 3 B state:

- The PRA and CPMA will, as a matter of course, consult each other on rules which they think may be relevant to the activities of the other; and
- Similarly, the CPMA will be required to consult the PRA in advance of taking any decision that could cause a firm-specific financial stability risk...

The difficulty here is the assumption that each party will understand the other so perfectly that they will correctly identify issues of relevance to each other. We suspect that they will not. Not only will simple human error get in the way, but there may be natural incentives to fail to identify these issues. Consultation and cooperation take time and tends to lead to compromise. Agencies with a clear focus and a determination to meet their goals may be disinclined to compromise.

Strong processes must be put in place to support cooperation and communication. These processes should ensure that all PRA and CPMA activity be reported to the other party so that each side can interpret for itself the potential impact on its area of activity. A common data system should be used across both the PRA and CPMA so that information can be shared at relatively low cost. Communication between and cooperation across the agencies should be a specific area of accountability for both the PRA and CPMA.

Tick box compliance

The society notes that the consultation paper is surprisingly light on the measures that will be taken to address the over-reliance on 'tick box' compliance.

There are several reasons why a culture of 'tick box' compliance might arise. First, the perception or reality of under-staffing might have left FSA representatives with too little time for any other approach. Secondly, the belief that the system was working well may have created a false sense of security that allowed such an approach. Last, poor management (lacking the direct experience of bank failure) may not have seen the need for persistent application of a more rigorous approach.

The experience of the most recent financial crisis is likely to mean that regulators are aware of the need for more effective supervision for some time, but poor management will always occur, the sense that the system is working well will not take long to be re-established and, as the memory of the financial crisis fades, regulators' ability to draw sufficient funding will likely weaken.

To limit the danger of a return to 'tick box' compliance, HM Treasury should review supervisory best practice internationally and set in place processes to be followed by supervisors within both the PRA and CPMA. Judgment will always be required, but it must be applied within a strong process so that the correct levels of supervisory investigation are taken across market cycles. Colleges of supervisors (as described by CEBS and the IWFC) will likely be a useful source of information on supervisory best practice. Supervisors at both the PRA and the CPMA should be required to report regularly on their adherence to supervisory best practice.

Accountability

HM Treasury's paper was borne from an understanding that the existing, tripartite system had failed and that a new structure should be put in place that would address the failings of the current approach. CFA UK notes, though, that the accountability processes that the consultation paper proposes for the new entities is essentially the same as the one currently used. It is clear that accountability has been insufficient in recent times and this area of the paper should be strengthened.

In CFA UK's opinion, the accountability mechanisms set out in 4.36 are good, but insufficient. Annual reports and annual meetings rarely provide an opportunity for meaningful review of performance. Consultative panels are – as their name suggests – consultative. They can be ignored. While the NAO and PAC will no doubt scrutinise the CPMA's accounts, neither body is well-placed to assess its performance.

CFA UK believes that the responsibilities and powers of the non-executive directors at the CPMA should be described in more detail so as to include the right for those directors to demand an external audit of the authority's performance and/or the performance of the CPMA's management. The non-executive directors should be required to meet regularly with senior representatives of firms that are regulated by the CPMA, with representatives of consumer groups and with senior executives at firms that rely on the efficient operation of the markets governed by the CPMA. This feedback ought to be recorded and reported annually and should be taken into account in determining the effectiveness of the CPMA in meeting its goals.

CFA UK believes that it is important that targets for the CPMA relating to the primary and secondary objectives should be published. The primary and secondary objectives for the CPMA are set at an appropriately high level. The CPMA's executive team should be required by CPMA's Board to set specific sub-targets relating to each of these objectives and the authority's performance relative to these targets ought to be reported by the Board.

A consumer champion

CFA UK is concerned about the focus within HM Treasury's paper on the CPMA's proposed role as a consumer champion. Clearly, protection of the consumer is of paramount importance and the conduct of business regulator should have consumer protection as one of its key objectives. CFA UK

believes that consumer protection requires that market integrity be assured through consistent rule-making, supervision and enforcement. HM Treasury's paper acknowledges the importance of market integrity by proposing the establishment of an autonomous markets division within the CPMA. CFA UK believes that this arrangement should be reversed, so that the bulk of the CPMA's activities are related to the protection of market integrity (a necessary condition for consumer protection) with the subsequent establishment of a specialist consumer protection division within the authority. CFA UK believes that the provisionally named CPMA ought to be named the Markets and Consumer Protection Authority.

Nevertheless, we respect the paper's intention to establish a regulatory framework that assures strong protection for consumers. There is sufficient recent history – for instance, endowment mortgages, split capital investment trusts – to demonstrate that close regulation is required for consumers to be treated fairly. Establishment of a specialist consumer protection group within the new body would certainly be justified.

However, organisations require focus. CFA UK believes that the CPMA's primary objective (as set out in 4.6) should be rewritten as: 'The government will legislate to provide the CPMA with a primary objective of ensuring confidence in financial services and markets, *with particular focus on ensuring market integrity and, thereby, protecting consumers*. In a similar vein, we would discourage HM Treasury from introducing a third set of objectives for which the CPMA should have regard. Ensuring market integrity is a steep ambition. The CPMA should not be diverted from that objective by the dilutive influence of a series of other intended outcomes.

Europe

As has been noted by other respondents, the proposed structure for UK financial regulation (FPC, PRA and CPMA) does not mesh well with arrangements at a pan-European level. Only one UK representative agency can participate in the new European Securities Markets Authority. The CPMA should be that agency, but if it is to take on that role, it should not lose responsibility for the UKLA to the FRC. The CPMA will need to cooperate and communicate closely with the FRC and PRA in order to represent UK interests successfully in Europe. The proposal to move the UKLA to the FRC appears unjustified irrespective of the need for effective representation in Europe. The need to support the CPMA's representative role in Europe tips the argument firmly in favour of the UKLA remaining within the CPMA.

Concluding remarks

Changing the regulatory framework is not a guarantee of an improved outcome. HM Treasury's paper suggests that the proposed changes will have certain results. For instance, 2.41 reads: '*The chief executive of the CPMA will sit on the FPC. This will ensure that any systemic risks arising from the activities regulated by the CPMA are correctly captured and identified and that any impact of the FPC's decisions on those activities is adequately taken into account*.' There is too much confidence within this statement. First, there is no guarantee that the systemic risks arising from activities regulated by the CPMA will be correctly captured and identified. That is an appropriate intention, but it is unlikely that it will be perfectly met. Similarly, the presence of an individual on a Board should allow appropriate information to be shared within that group, but it does not guarantee that

will happen or that information that is shared will be taken adequately into account. That will be a matter of opinion, which may differ among Board representatives.

The tone of the document suggests that HM Treasury believes that restructuring the regulatory framework will eliminate regulatory failure. It will not. While we support most of the proposals within the report, we believe that the paper contains too little detail on how the new regulatory framework will lead to operational excellence. More emphasis should be put on accountability, best practice in supervision and measures to promote communication and cooperation between the PRA and the CPMA. Further, the CPMA should be allowed to focus primarily on ensuring market integrity while making sufficient provision to ensure the proper protection of consumers.

About CFA UK and CFA Institute

The CFA Society of the UK (CFA UK) represents the interests of more than 9,000 leading members of the UK investment profession. The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members. Most CFA UK members have earned the chartered financial analyst (CFA) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute is the global association for investment professionals. It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry. CFA Institute has more than 99,000 members in 139 countries, of whom more than 88,000 hold the Chartered Financial Analyst® (CFA®) designation.

Yours,

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