

Understanding the source of the shift to PBR is extremely helpful in understanding the regulatory ills it is designed to cure. The term came into general use in 2006 following a speech by John Tiner on the 13th October 2006 when he said “Today, I would like to take the opportunity to discuss our move towards more principles-based regulation - a topic that I regard as central to the future of the FSA and of UK financial markets. I believe that a significant tilting of the balance towards principles is essential.”

In fact the roots of this idea were voiced in a report by the Centre for Political Studies (CPS) published in March 2005, entitled “The Leviathan is still at large”. This superb report reaches a consensus about how best to take financial services regulation forward.

Importantly, the report took account of the intangible and anecdotal comments of the senior managers from the industry and stressed that confidence in the regulator cannot be measured through hard data but was nevertheless of critical importance to achieve success. That success could be expressed as a regulatory environment where cost is proportionate to risk and a healthy, competitive and innovative industry flourishes.

The research identified five areas of concerns from industry leaders which I personally have heard voiced many times and they will no doubt sound genuine to the reader:-

Regulatory culture and communication - To describe the FSAs culture, descriptions such as such as arbitrariness, lack of consistency, defensiveness, box ticking, bureaucratic and distant were used by industry leaders.

The level of consultation papers being issued at this time was excessive and The FSA adopted an objective to reduce these. However, simply reducing the number of communications was seen as only part of the problem. A bigger issue was the remoteness of the FSA and the feeling that by the time the industry are asked for their opinion the decision has been made.

Regulatory competence and quality - Culture is discernable by communicating with staff and a major concern was the high level of turnover and lack of industry knowledge. These aspects the FSA continues to grapple with.

Consumer capture – There was a distinct impression that the FSA was being hijacked by the consumer lobby leading firms to take a defensive position.

Costs and burden of regulation – The level of detail and time management spend on regulation was distracting leaders from their main purpose which is to manage competitive and innovative businesses. There was also concern that the industry was abandoning the mass markets where returns were longer competitive after costing the burden and risks of regulation.

Competitiveness – Both nationally and internationally the burden of regulation was seen to be having a serious effect on the UK's competitive position

Traces of the recommendations made in the paper can be seen in some of the changes made by the FSA in the last two years, namely:-

- Clearly differentiating between retail and wholesale business
- Recognising the competence of senior management to manage their own business risks (although this is probably up for further debate in the light of recent developments!)
- Improving the robustness and consistency of the enforcement regime
- Developing a culture of partnerships with industry representatives by involving trade bodies in working parties and holding informal meetings with business leaders

A key recommendation in pursuit of the goal to encourage a healthy, competitive and innovative industry was to adopt a light touch regime “subject to overarching broad Principles, expressly adapted for the business and market needs of each market sector and supported by formal, targeted guidance on how the regulator expects the principles to be interpreted by the industry.”

Just ahead of the time that this paper was published in March 2005, Dr Thomas F Huertas, Director of the FSA’s Wholesale Firms Division had said in a speech on the 8th February “First, we see the FSA principles, rather than rules, as the backbone of our regulation.”

By October 2005 the term Principles Based Regulation was starting to become a repeated theme in all speeches with probably the best explanation being provided by Andrew Whittaker, Director of the General Counsel Division, who said “Finally, we aim to be principles based. By this, we mean relying on general principles, rather than detailed rules, where we can. This has two advantages. The first is that it provides flexibility for firms to decide how to comply, so long as they deliver the result. The second is that in our view it provides better quality regulation than simply a mass of detailed rules, of the kind so effectively avoided in the Enron case.”

The question of where the idea originated will probably remain one of debate although my money would go on the CPS, given the evidence of other initiatives that closely mirror their recommendations. In any event the reasons for the recommendation are more important in following the way in which this initiative has developed and how we take it forward to support a future where a “grown up” relationship exists between the regulator and industry.

An important lesson for the industry to learn from the past is to persevere in efforts to take advantage of this new PBR world rather than, once more, lose sight of the Principles in the demand for clarity, as happened in the early days of regulation by the SRO’s.

The next article will bring readers up to date on the development of PBR and how the FSA seem to take one step forward and two steps back in reconciling the fear of chaos with the security that rules offer. The last article in the series of three will tackle the real challenges of HOW, exactly, can the industry shift its own compliance approach to take the advantages that this approach offers.

Series of three articles published by Complanet : Principles Based Regulation

1. Whose idea was it anyway and why?
2. The current thinking and clues from TCF
3. HOW to make the shift to principles based compliance

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