

PART THREE

Influencing and representation internationally

The FSA's effectiveness in influencing and representation internationally requires: it to be clear on what it aims to achieve; effective co-ordination with other parts of UK Government, in particular HM Treasury; close engagement with EU and international institutions; and clear communication of these activities to the UK financial services industry who are affected by EU and international regulatory developments.

This section of the report shows:

■ influencing European financial supervision

The FSA has cooperated with other UK organisations to promote successfully the Better Regulation agenda in Europe. HM Treasury is the UK's principal negotiator on financial services and markets at the European Union and the FSA works closely with HM Treasury to develop the UK's position on emerging European legislation and its implementation. It is influential in European discussions and also engages effectively with the European Commission and other member states. The key elements of the FSA's strategy are disclosed each year in the FSA's annual business plan and International Regulatory Outlook. Stakeholders generally consider that the FSA does reasonably well in a complex and difficult environment, although some are unclear about the FSA's aims and approach in Europe or question the level of coordination with HM Treasury. This presents the Authority with a clear, but difficult, communication challenge to overcome (paragraphs 3.5 to 3.27).

■ influencing financial supervision outside the European Union

The FSA is a leading international regulator. It has achieved important results in global coordination, for example with the US regulatory authorities on administrative backlogs in the settlement of some types of financial instrument, and it is widely respected for its thought leadership on issues such as risk-based regulation (paragraphs 3.28 to 3.32).

Influencing and representation at the EU level

3.1 The European Commission's objective is to promote the European internal market in financial services to enhance European competitiveness and bring economic benefits. Its Financial Services Action Plan consists of 42 measures covering a wide range of areas including investment funds and services, capital requirements, prospectuses, accounting, pensions and reinsurance. In recent years most new financial regulations have derived from Europe, rather than the UK Government or the FSA. There is some unease in the UK financial services industry (including the FSA) about whether the compliance burdens imposed by European-derived regulation can always be justified in cost benefit terms.⁵⁵

3.2 For example, the FSA has recently published a commentary on the overall costs and benefits for the UK of the Markets in Financial Instruments Directive (MIFID) (**Figure 10**).⁵⁶ This shows that the overall costs and benefits of MIFID are difficult to estimate with precision. In particular the quantification of benefits is problematic. The FSA's commentary also noted that the benefits for emerging EU markets are likely to be more significant in relative terms than for fully developed markets like the UK.

3.3 For each directive, it can take several years from initial negotiations to final implementation in Member States. For example, **Figure 11** shows the timeline for MIFID which started with a Commission consultation on upgrading the Investment Services Directive in November 2000 but which will not be implemented in Member States until November 2007. MIFID is the FSA's largest single project in terms of staff resource. Since March 2005, the FSA has spent some 18,200 days on its MIFID implementation project.

10 Case study – Assessment of the costs and benefits of the Markets in Financial Instruments Directive (MIFID)

To demonstrate the importance they attach to the value of cost-benefit analysis and given the wide-ranging nature of MIFID, the FSA and HM Treasury decided to comment on the costs and benefits of the MIFID directive.¹ The FSA published their estimates in November 2006 which attempted to assess the overall costs and benefits of MIFID for the UK.

Broadly the FSA estimated that MIFID could plausibly be estimated to generate quantifiable benefits of up to £200 million per year in direct benefits, accruing principally to firms in the form of reductions in compliance and transaction costs (and another £240 million in 'second round' effects²). On the costs side, they estimated quantifiable one-off costs of some £877 million to £1.17 billion for firms and additional on-going costs of £88 million to £117 million per year.

Source: National Audit Office

NOTES

- 1 Joint Implementation Plan for MIFID, May 2006.
- 2 These benefits, which are contingent on the direct benefits arising and are thus subject to some additional uncertainty, would accrue to the economy as a whole from deeper and more liquid capital markets rather than to individual firms.

3.4 The process by which the European Commission makes, implements, monitors and enforces financial services legislation is based on the proposals of the Committee of Wise Men on the Regulation of European Securities Markets, chaired by Baron Lamfalussy.⁵⁷ This approach has created four stages or "levels": framework principles, implementing measures, co-operation and enforcement. A number of legislative proposals central to the Financial Services Action Plan have been taken through this specific legislative procedure developed to keep pace with fast evolving financial markets.

The role of the FSA in Europe

3.5 The Government is responsible for the negotiation of legislation originating in the EU affecting financial markets, providers and consumers of financial services. In practical terms, this means that HM Treasury leads on the negotiation of most of the legislation affecting financial services, as well as leading the UK's representation to EU institutions, together with the UK's Permanent Representative, on strategic issues, such as the future direction of financial services policy in Europe.

11 The timeline for the implementation of MIFID

Level 1 – Framework directive	Date
Commission consultation on upgrading the Investment Services Directive	16 Nov 2000
Commission proposal	19 Nov 2002
European Parliament First Reading	25 Sep 2003
Parliament Second Reading	30 Mar 2004
Directive adopted	27 Apr 2004
Level 2 – Detailed implementing measures	
Commission formal request for CESR ¹ technical advice on possible implementing measures	25 Jun 2004
CESR delivers first advice to the Commission	3 Feb 2005
CESR delivers second advice to the Commission	3 May 2005
Commission releases draft implementing measures for MIFID	6 Feb 2006
EU Parliament adopts technical measures for implementing MIFID	15 Jun 2006
ESC ² adopts technical measures for implementing MIFID	26 Jun 2006
Publication in EU Official Journal of implementing measures under MIFID	2 Sep 2006
Transposition date into UK law	31 Jan 2007
Implementation deadline for MIFID in the UK	1 Nov 2007

Source: National Audit Office

NOTES

- 1 The Committee of European Securities Regulators.
- 2 The European Securities Committee.

3.6 In the context of the Lamfalussy procedures outlined above, this means that the Treasury represents the UK at the framework legislation stage, (negotiated for the most part under the codecision procedure), and on the supporting committees (negotiating more detailed implementing measures beneath the framework legislation). The FSA takes part in the committees of regulators known as the “Lamfalussy committees” - but these do not have a legislative function. Under FSMA, the FSA is also responsible for detailed implementation of the resulting legislation into UK law, and its enforcement, although the Treasury is responsible for amendments to primary legislation to ensure the FSA has the necessary powers. The Government is ultimately accountable as a signatory to the Treaty and would deal with any infraction proceedings. This split of responsibilities differs from the domestic picture, where the responsibility for many decisions and rules lies with the FSA.

3.7 The Lamfalussy committees of national regulators provide detailed, professional advice to the European Commission on the technical implementing provisions or secondary legislation needed to flesh out Directives. The committees also provide a forum where issues of common concern and potential solutions can be discussed and where supervisory convergence can be advanced. The FSA represents the UK in the committees of national regulators. The relationship between the Lamfalussy committees and other key EU institutions is illustrated at Appendix 3a.

3.8 This structure creates a series of constraints on the FSA’s capacity to shape the development of European financial regulation and means it can seek to influence, but cannot ultimately control, the outcome of negotiations in Europe:

- The UK is one of 27 Member States in the EU, and decisions in the Council are taken by qualified majority voting.⁵⁸ This means that decisions do not need unanimity across all Member States before they are passed, and so no one state can hope to control the process.⁵⁹ As a Member State, the UK must implement EU law in the UK.
- All Member States have an interest in directives that affect the retail markets. A smaller number has an interest in proposals affecting wholesale financial markets. The UK, as a leading global financial centre, has a keener interest in new regulations affecting wholesale markets than other Member States. In general, stakeholders we interviewed considered that the FSA has been influential on the regulation of wholesale markets and had done well in a difficult environment where the UK has few natural allies. However, the regulation of retail markets is driven by domestic political agendas in each Member State. Stakeholders generally considered that, for these reasons, the FSA had not influenced negotiations to the same degree.
- Negotiations in the EU involve national and political sensitivities. This means that HM Treasury may judge that the UK’s wider interests are best served if it agrees to a compromise on some issues. As a consequence, the FSA may have to accept a less than optimal outcome in negotiations on a financial services directive. Conversely it can be difficult for the FSA to promote its own successes to UK stakeholders without potentially destabilising relations with non-UK audiences in Europe.
- The European Commission has increased the number of “maximum harmonisation” legislative measures as a way of imposing common rules in specified areas which they consider is more effective at delivering a coherent single market. Effectively this approach works as an “anti-gold plating” clause. It prevents national regulators introducing regulatory additions at a national level. The FSA disagrees with this as a general approach and considers that a high level, principles-based directive should enable sufficient convergence, whilst allowing room for manoeuvre in implementation to address country-specific risks.⁶⁰ The use of “maximum harmonisation” by the Commission may constrain the FSA by removing aspects of consumer protection for UK consumers. For example, the FSA considers that the “maximum harmonisation” approach on MIFID implementing measures may significantly limit the scope to add or retain Conduct of Business requirements on firms that the FSA regards as central to the maintenance of consumer protection. In some areas of MIFID the FSA has sought to retain requirements which go beyond the Commission’s measures.
- The European Central Bank (ECB) is increasingly looking to influence European financial services regulation. The Bank is an advocate of a single EU rule book for banking services. It has also proposed Europe-wide regulation of settlement services in the “eurozone”, even though the Commission had adopted a Better Regulation approach in the form of an industry code on clearing and settlement with infrastructure providers, thereby delivering an alternative to legislation.⁶¹

Resources devoted to EU work

3.9 The FSA decided in 2004 that responsibility for European Union and international representation on specific issues should lie with the line managers who have the relevant sector-specific expertise and are responsible for the respective domestic policies. While European and international policy work is embedded in the FSA's business units, the FSA also considered that it was important that the FSA had the capacity to maintain an overview of international policy developments and established a strengthened International Strategy and Policy Co-ordination Department. The Department helps FSA senior management to influence thinking on European and international policy at an early stage and monitors developments.⁶² The Department also acts as the FSA's relationship manager with a number of key stakeholders in the international arena.

3.10 Representatives of the FSA's senior management sit on the main committees of national regulators that provide technical advice to the Commission and they have chaired influential sub-committees such as:

- CESR⁶³ Expert Group on MIFID Intermediaries (FSA's Chairman).
- CESR Operational Group: Enforcement of Financial Information disclosed by listed companies in the EU (FSA's Chief Executive).
- CEIOPS⁶⁴ Solvency II Pillar 1 Expert Group (FSA Head of Department).
- CEBS⁶⁵ Expert Group Capital Requirements Directive (FSA Managing Director – until mid-2006).

3.11 Other FSA staff sit on or chair a range of expert and technical working groups. The FSA also has a number of secondees at the Commission and in the secretariats of the committees. Each year the FSA devotes a significant level of resources: some 38 person years on EU directive negotiations and a further 24 person years on the committees.⁶⁶ Included in these figures are 120 days of director level and above resource and the Chairman alone spent 42 days out of the country on EU and international business in 2006.

3.12 In addition, since January 2005 the FSA has produced a regular publication – *International Regulatory Outlook* – to inform and update industry on European and international issues, and, in particular, to highlight the extent to which new regulatory requirements arising from international initiatives, particularly European Union legislation, are likely to have an impact on consumers, markets and regulated firms.

The FSA's objectives for EU influencing and representation

3.13 The FSA does not have a formal statutory objective in relation to EU influencing. It does not view its role as creating or protecting UK 'national champions', nor as a national advocate seeking to direct the EU debate. The FSA's aim for its European work is to ensure that regulation is proportionate, consistent with a principles-based approach and assists in achieving FSA objectives. The FSA seeks to achieve these objectives in four main ways:

- Early engagement on specific measures.
- Supporting a properly functioning European regulatory architecture.
- Promoting and facilitating the use of Better Regulation methodologies.
- Encouraging a more principles-based approach.

Early engagement

3.14 The FSA monitors potential and forthcoming proposals and attempts to understand early their purpose and implication for the UK. It agrees an approach with HM Treasury (which remains the principal negotiator of EU measures) ahead of negotiations and highlights strategic issues for the UK. It may provide suggestions on wording or scope for draft proposals. It collaborates with the other regulators on Lamfalussy committees and tries to influence the advice provided in response to requests from the Commission. It also offers technical advice to MEPs, although it views lobbying of non-UK MEPs as the role of the UK's Permanent Representative and HM Treasury. Appendix 3b illustrates the FSA's and HM Treasury's roles and methods of influencing at each stage of the EU policy-making process.

Supporting the European regulatory architecture

3.15 The FSA is committed to making the existing regulatory structures in the EU work well. Its preferred approach to the future of financial services regulation is based around effective collaboration of national regulators using the Lamfalussy structure. It has four objectives for making EU decision-making structures work better:

- Progressing arrangements for enhanced supervisory cooperation (including promoting home/host co-operation with other EU regulators).⁶⁷
- Encouraging greater co-ordination between the Lamfalussy committees on cross-cutting issues.⁶⁸
- Greater use of peer group review to ensure effective implementation of measures, including monitoring to check that implementation is consistent with the directives.
- Embed the use of impact assessments in the work of the Lamfalussy committees.

Better Regulation

3.16 The FSA has actively promoted Better Regulation in the EU, both in the Commission and in the Lamfalussy committees. In December 2005 the Commission's White Paper⁶⁹ committed to:

- open and timely consultation;⁷⁰
- greater use of impact assessments;
- consideration of alternatives to legislative proposals (such as greater use of competition powers, or industry codes); and
- ex-post evaluation of regulations.

As part of its Better Regulation drive, the FSA has also taken a clear stance on some potential European policies. For example, in its latest *International Regulatory Outlook* report, it argued that Europe-wide regulation of mortgages did not seem necessary because there was not at this stage any clear-cut evidence of a market failure in national mortgage markets across Europe.

A more principles-based approach

3.17 The FSA is advocating the greater use of principles as a way of delivering more proportionate regulation in the EU. It recognises that, despite the widespread endorsement of Better Regulation, it may take some time before there is a decisive shift to more principles-based regulation in the EU. Commission staff, like those in many firms and regulators, understand rules and are comfortable with them. Legal and cultural traditions vary widely among Member States and in some cases there are legal impediments to adopting a more principles-based approach.⁷¹ In addition, there is a potential risk that the principles in the directives will not necessarily align with the FSA's own principles.

FSA's performance in Europe

3.18 London is the most prominent European financial centre. More international banks are based in London than elsewhere, and more financial transactions are conducted in London, both on an off the main exchanges such as the Stock Exchange, than elsewhere. In addition, a recent high-profile report by McKinsey & Company⁷² found that London's relative position as a financial centre had improved in particular compared with New York in the last three years, and a report published by the City of London Corporation in November 2005 highlighted that London and New York had in the last few years moved further ahead of Frankfurt and Paris as international financial centres.⁷³ These reports identified the FSA's regulatory regime as a significant factor in relation to the emergence of London as the most prominent European financial centre. It is difficult to disentangle the FSA's contributions to these developments from the contribution of others, such as the City of London Corporation, which has been very active, including opening its own office in Brussels and coordinating the input of UK trade associations into strategic European decision-making processes.

3.19 Stakeholders generally consider that the FSA does reasonably well in what is a complex and difficult environment, in particular at engaging early with the Commission to influence early thinking and draft proposals. In the Financial Services Practitioner Panel survey, a majority of respondents felt that the FSA was "alert to emerging EU issues and prepares its position in time". However, slightly more disagreed than agreed that "the FSA is suitably co-ordinated with HM Treasury" on EU and international issues. Roughly a third of respondents did not have an opinion. The Panel considered that the FSA's work in the EU and international arenas is of high technical quality and might merit being promoted more effectively to the industry at large.⁷⁴

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3.20 This may indicate that the FSA should enhance its communications with industry by explaining more clearly to the industry what the FSA wants to achieve in Europe, the context of EU negotiations, the level of commitment of senior FSA staff, the interaction between FSA and HM Treasury, and periodically demonstrating, in a published report, how far it has met its objectives. An enhanced *International Regulatory Outlook* report may be one way for communicating these messages. Achieving this may require clarification of the balance of responsibility between the FSA and HM Treasury for communicating high level messages on European issues to industry.

3.21 Members of the committees of national regulators that we interviewed also commented positively on the FSA's participation, in particular that of the FSA's senior management. They perceived the FSA as being influential and respected, and a leader in terms of regulation of wholesale markets in the EU. Stakeholders, including the Financial Services Consumer Panel, commented favourably on the level of consultation by the FSA with industry and consumer interests, especially in comparison with the more limited efforts at consultation by other Member State regulators.⁷⁵ As **Figure 12** shows, the FSA was instrumental in promoting a non-legislative solution on how to regulate credit rating agencies, when several other countries favoured a more traditional form of regulation by directive.

3.22 The UK has a good record in terms of implementing financial services directives on time and the FSA considers it brings advantages:

- It can give the FSA the opportunity to influence the way other Member States implement the directive.
- It avoids the risk of the Commission taking infraction proceedings against the UK.
- It can provide a competitive advantage to UK firms over European rivals whose governments implement the directive behind schedule.

Future issues

3.23 Since the Commission first embarked on the Financial Services Action Plan in 2000, there has been a major shift in thinking about regulatory approaches. The Commission has made a commitment to greater use of impact assessments and to subject all existing measures to post-implementation review. There are now therefore more explicit opportunities for the FSA systematically to influence the development of European policies at an early stage, and it should ensure that it does. For example, now the Commission has made a commitment to produce impact assessments supporting all new legislative proposals, the FSA can subject these to scrutiny.

12 Case study – credit rating agencies

In 2004 the FSA identified a growing issue of whether or not credit rating agencies were a potential source of market failure and therefore how they should be regulated. The FSA favoured a non-legislative solution and considered one was feasible. It promoted this in the EU and internationally through IOSCO. The FSA found that they were relatively isolated in Europe at first, as most other countries were minded to support the formal regulation of credit rating agencies. In July 2004, the Committee of European Securities Regulators (CESR) was asked by the Commission to provide technical advice on this issue. The FSA participated in the CESR Task Force set up to respond to this request for advice. During this period, the FSA also played an active role in the work of IOSCO which culminated in a Code of Conduct for credit rating agencies, which encouraged agencies to state publicly whether they complied with the Code or if not to explain why (known as a "comply or explain" model of enforcement). The CESR work resulted in a consultation paper in late 2004, which set out a variety of options, the vast majority of responses from all parts of the market argued in favour of there being no EU regulatory intervention at that time, given the recent introduction of the IOSCO Code and other relevant factors. The FSA was influential in persuading CESR to advise the Commission to adopt a "wait and see" approach. In January 2006 the Commission announced that it agreed with CESR's approach and that no new legislative initiative was needed, but that the situation would continue to be monitored. Under the agreed approach, credit rating agencies will send an annual report to CESR on their compliance with the IOSCO Code, and meet members of the Task Force to discuss their report, and report any significant incidents to CESR. CESR is also required to report back to the Commission annually.

Source: National Audit Office

3.24 There is still some way to go on the practical application of Better Regulation by the Commission and the Lamfalussy committees.⁷⁶ The FSA considers that it is not yet clear that the commitment to Better Regulation has permeated all levels of the Commission, nor the extent to which there will be the necessary commitment in the EU policy-making process to allow the time and resources to be devoted to these disciplines in future. In particular, whilst the FSA has welcomed the Commission's recent impact assessments, it considers that the Commission needs to improve the quality of the assessments and allow sufficient time for them to be carried out at key stages and to be consulted on.⁷⁷ The FSA has provided the Commission with technical advice and support to strengthen the approach for impact assessments.

3.25 There are issues that may undermine the effectiveness of the current Lamfalussy arrangements to secure greater convergence of national regulatory approaches:

- There is an on-going risk that EU supervisory convergence is not successful because the Lamfalussy structures become increasingly hard to operate. The Committees may also become too cumbersome or because the will to achieve meaningful regulatory convergence does not really exist (for example if the mediation mechanism for resolving significant differences of approach were not to be effective).
- Regulatory convergence is also made more problematic if Member States do not meet the agreed deadlines for transposition of Community law. The Commission considers that the rate of transposition by Member States is weak, and as a result companies cannot benefit fully from pan-European access.⁷⁸
- The Davidson Review⁷⁹ reported that differential implementation across Member States matters more to businesses that operate across Europe than whether there is over-implementation of directives.

The FSA is committed to making the Lamfalussy arrangements work. The FSA is working to get its message across, particularly as the EU's Inter Institutional Monitoring Group is currently exploring the effectiveness of the Lamfalussy approach and will report later in 2007.

3.26 In the EU the optimal structure of financial regulation in Europe has become a subject of debate⁸⁰, particularly among Government and Commission officials, regulators and the leaders of major financial enterprises with operations across Europe.⁸¹ The FSA and HM Treasury support the existing Lamfalussy arrangements as do other influential UK commentators.⁸² However there are alternatives to the existing structures, including a single EU rule book,⁸³ a lead supervisor for cross-border financial institutions,⁸⁴ or the so-called single EU regulator (i.e. a European FSA).⁸⁵ Over the next few years, there may be growing pressure for radical reform of the regulatory structure for financial services. The FSA prefers to avoid entering into a debate on alternatives to the existing structures particularly given the speculative nature of the proposals. Some stakeholders we interviewed suggested that the FSA, as the regulator representing the largest financial services market in Europe, should adopt a higher public profile in promoting its vision for the future of European financial services regulation.

3.27 The scale and importance of the future issues facing the FSA in Europe suggest that the staff time devoted by FSA's senior management should at least be maintained or possibly enhanced, so as not to diminish the FSA's capacity to influence and achieve beneficial outcomes for the UK in Europe.

Influencing at the international level

3.28 Global institutions are important channels for arriving at a common understanding of issues and developing sound practice. The FSA estimates that they devote around 21 person years in total to the work of global fora including:

- the Basel Committee on Banking Supervision;
- the International Organisation of Securities Commissions (IOSCO);
- the International Association of Insurance Supervisors;
- the Financial Action Task Force; and
- the Joint Forum and the Financial Stability Forum (FSF).

3.29 The fora are important as they set global standards and develop policy at an early stage, which in some cases can subsequently lead to or influence EU measures. For example, the EU Capital Requirements Directive recasts existing directives to incorporate a revised capital adequacy framework (Basel II). The FSA played a leading role within the Basel Committee on capital adequacy. The FSA's objectives are to ensure that these institutions are focussing on the right issues; have focussed agendas and do not duplicate effort.

3.30 The National Audit Office interviewed a number of other overseas financial services regulators (primarily in the securities field). The common view was that the FSA is one of the leading regulators in their field:

- **International engagement:** The FSA is highly respected and influential in the IOSCO and FSF forums and resources its international work well. The FSA's staff are considered to be high-quality and they bring an intellectual weight to the discussions of these international bodies. As the regulator of a leading international financial centre, the FSA is a strong advocate of international co-operation and chairs a highly influential sub-committee of IOSCO in this area.

- **Role model:** The FSA is regarded as a leading advocate and role model in terms of risk-based regulation, and in bringing about a Better Regulation focus on the costs, burdens and benefits of regulation. Regulators welcomed the FSA's willingness to explain to them their regulatory approach in a constructive way.
- **Thought-leadership:** The FSA was considered strong at identifying emerging issues ("horizon scanning"), conducting high quality evidence-based research and tabling it for discussion at international fora. Examples included FSA's research on credit derivatives (**Figure 13**), hedge funds, private equity, and financial reporting standards.
- The UK's arrangements for **financial stability** (a tri-partite arrangement between the FSA, HM Treasury and the Bank of England), were considered to provide models of good practice that other countries could use to inform their own arrangements.

3.31 An on-going issue for the FSA is how far to harmonise and standardise with other financial regulators, in particular those of the US and other leading international financial centres. A global association of leading financial institutions has called for a strategic dialogue on effective and efficient regulation, and prioritising global coordination as an essential part of any jurisdiction's regulatory process.⁸⁶ The recent report by McKinsey & Company (paragraph 3.18) noted that there was a trend toward US-headquartered firms shifting leadership of certain corporate and investment banking businesses from New York to London, as well as a number of other big US firms shifting high-level decision-makers to London.⁸⁷ The Report drew attention to the perceived superiority of the UK's regulatory environment, including the UK having a single integrated financial regulator, and a more principles-based approach. In addition to this report, there have been other calls in the US for changes to its regulatory environment.⁸⁸ These calls for the US to review its regulatory approach may provide further opportunities for the FSA to work with its US regulatory counterparts on harmonisation of approaches and to work in a coordinated manner, for example on broking commissions (so-called "soft dollar" rules); rulebooks for broking activities; and financial reporting software standards.

3.32 The City of London Corporation noted in its November 2005 report that "if there is to be a third global financial centre (after New York and London) it is likely to come from one of four or five potential candidates in Asia, not from Europe."⁸⁹ With the emergence of Asia-Pacific markets, there may be opportunities for the FSA to seek to harmonise approaches and rules with the regulatory authorities in these markets.

13 Case study: credit derivatives and bilateral working between FSA and other regulators

The credit derivatives market has grown exponentially from \$3¼ trillion in 2003 to \$26 trillion in 2006. Currently more than 80 per cent of the volume of the credit derivatives market is in London and New York, with the majority in London. This rapid growth resulted in a backlog as back office functions could not keep pace with trading activity. In April 2004, the FSA became aware for the first time of a backlog at a meeting with a leading investment bank. The bank decided to shut down this side of their business until the backlog was reduced. Consulting more widely, the FSA found similar problems in other market participants.

The FSA encouraged the Joint Forum¹ (chaired by the FSA at the time) to look into the credit derivatives market to identify risks and to make recommendations regarding their possible mitigation. The result was an authoritative study on the credit derivatives market which contained recommendations for the public and private sector and attracted widespread market interest. The FSA hosted an industry roundtable in December 2004 to discuss the study's findings. Subsequently the FSA wrote a 'Dear CEO' letter to the heads of UK regulated firms in February 2005 which indicated that the FSA was concerned about the backlog.

The FSA alerted other international regulators such as the United States Federal Reserve and the German financial regulator (BAFIN). The Federal Reserve organised a meeting in September 2005 which included the US, German, Swiss, and UK regulators and industry members. It identified concerns about the backlog and concluded that if industry was not prepared to tackle it, the regulators would come up with a severe regulatory solution. At the meeting, the FSA presented figures to demonstrate the seriousness of the problem. The industry was asked to put forward a suggested solution. This involved market participants producing monthly figures for the regulators. The FSA and the other regulators agreed to meet every six months to monitor the market and to ensure the backlog was under control. A survey² in July 2006 showed substantial progress had been made by the industry.

Source: National Audit Office

NOTES

1 Joint Forum: a cross-sectoral group made up of the Basel Committee, the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors.

2 The Credit Derivatives Backlog Joint Survey.