



Better Regulation – more questions than answers

Ask a group of regulators if they believe in ‘better regulation’ and you will not get a negative answer from any of them. ‘Better regulation’ is a great slogan that has peppered the conversations of politicians, regulators and bureaucrats over the last few months, but what does it mean? Does ‘better regulation’ mean the same for a financial services regulator as it does for say a UK or EU parliamentarian? Are the ideas underpinning this concept equally shared, understood and agreed by all EU financial services supervisors? How will the development of this idea influence any conception of ‘better supervision’ and ‘better regulatory assessment systems’? Does it suggest a holistic approach, whether in the examination of a firm’s risk profile or in the assessment of any regulatory initiative?

Jose Maria Roldan, Chairman of the Committee of European Banking Supervisors (CEBS), has stated that¹ in his view the ‘better regulation’ approach as outlined in the EU Commission’s recent Green Paper on the direction of EU financial services policy² means ‘less regulation’. The EU Green Paper, however, is maddeningly imprecise. Apart from suggesting a series of priorities that appear to support ‘better regulation’, transposition, enforcement and continuous evaluation, the text of the Green Paper merely refers to the ‘better regulation’ approach as one that is principles-based and involves ‘simplification’. Is this really the detail behind Jose Maria Roldan’s remarks, or is he just asking for a pause in any further changes in the EU’s financial services policy?

Charlie McCreevy, in his Brussels address³ given in support of the Commission’s Green Paper, was careful to say that ‘better regulation’ is at the core of his agenda and that it has two elements. First, legislation must provide added value and address the requirements of all market participants. Second, new legislation must be accompanied by an impact assessment requirement so that the costs of any legislation are considered against clear benefits. He also suggested that his tests for any new regulation are whether there is a case for action, whether the EU is best placed to act, and whether less intrusive and less costly methods could achieve the same results as a regulatory proposal. McCreevy further emphasised the need for open and transparent policy-making, which could go as far as a single EU Financial Services Rulebook.

So do these positions help stakeholders get to the heart of what is ‘better regulation’? Or are we left with more questions? For instance, is openness and transparency an aspect of ‘better regulation’ or a requirement that sits over and above any other consideration? The same could be asked of McCreevy’s tests. Moreover, how are ‘added value’ and/or the ‘requirements of all market participants’ to be determined? Against what criteria or objective set will these latter questions be answered? A primary EU objective is the integration of European financial markets and the

¹ At the 18/07/2005 *Exchange Views on EU’s Financial Services Policy 2005–2010* event
http://europa.eu.int/comm/internal_market/finances/docs/actionplan/infosession/results_en.pdf

² For the EU’s *Green Paper on Financial Services Policy (2005–2010)*
http://europa.eu.int/comm/internal_market/finances/docs/actionplan/index/green_en.pdf

³ <http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/05/448&type=HTML&aged=0&language=EN&guiLanguage=en>



removal of any barriers to integration. So how can the yet to be realised benefits of truly integrated capital markets be measured or understood in advance of integration?

Callum McCarthy, in his opening remarks at the 21/07/2005 FSA annual public meeting, spoke directly about the need for cost-benefit analysis and in doing so appeared to take a particular swipe at the Market in Financial Instruments Directive (MiFID).⁴ He seemed to suggest that the MiFID – which essentially grants EU passports to MiFID firms in exchange for the adoption of a set of uniform pan-European rules on how those firms conduct their business – might not pass any such cost-benefit analysis.

So on what formula should a cost-benefit analysis be based? If the MiFID is to be assessed from a ‘better regulation’ perspective, does this suggest, as implied by the EU’s Green Paper, that it should be reviewed in conjunction with existing or incoming legislation or related regulatory initiatives? If so, then what does this imply for the MiFID as it relates to the current review of the asset management industry⁵ or the draft Capital Requirements Directive (CRD) or any operational risk framework requirements that may be implied under the CRD but are definitely required under finalised Basel II text of June 2004?⁶ With regard to the CRD, can any prudential framework that directly considers operational risk ignore the contribution of controls, some of which are aligned with the MiFID’s conduct of business rules, to the mitigation of prudential risk? Should a ‘better regulation’ assessment of the MiFID consider the MiFID’s potential contribution to a firm’s internal control system, recognising that internal controls have a prudential as well as a reputational dimension for many firms and thereby support a holistic understanding of a firm’s business and controls risks? Would such an approach, augmented by improved supervisory transparency, not support some common view of ‘better supervision’?

The revised CP03 – a recent CEBS consultation document concerned with the Pillar 2 supervisory review process under the CRD – may provide us with further guidance on current supervisory thinking on the internal controls. Most importantly, internal controls are included in the document’s description of the firm’s own Internal Capital Adequacy Assessment Process (ICAAP) and a supervisor’s own Supervisory Review and Evaluation Process (SREP). It is the interaction of SREP and ICAAP that will determine the Pillar 2 dialogue between a firm and its regulator. Central to the SREP is the supervisor’s own internal Risk Assessment system (RAS)⁷ and the supervisory building blocks. The problem starts with the building blocks which concentrate solely on business risks⁸ and make no mention of control risks and the control risk function.

⁴ http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2005/0721_cm.shtml

⁵ http://europa.eu.int/comm/internal_market/securities/ucits/index_en.htm#greenpaper

⁶ Although the Revised Framework (i.e. Basel II) Pillar 2 text makes direct reference to an operational risk framework and the Pillar 1 text directly references the BIS 2003 paper *Sound Practices for the Management and Supervision of Operational Risk* (<http://www.bis.org/publ/bcbs96.htm>), the EU’s CRD does not make these reference to either of these elements although the CRD draft text, to varying degrees, appears to be informed by these documents. How operational risk requirements are treated is of concern to EU firms with home supervisors that may wish to fill any gaps unaddressed by the CRD.

⁷ In the UK context, RAS would map to *The firm risk assessment framework* as published by the FSA in 2003

⁸ But implicitly including risk mitigants recognised under Pillar 1. These mitigants extend to insurance for those firms applying for and being allowed to adopt the advanced measurement approach (AMA) for operational risk.



The consultation on CP03 continues, but will its development be influenced by any ideas around 'better regulation' and the views of the UK presidency on this issue?⁹

The UK has announced that it plans to take its 'better regulation' agenda,¹⁰ which incorporates a risk-based approach, to Europe. So what is a risk-based approach? This is yet another term that is often uttered but rarely defined, although generally speaking, in the context of the UK financial services industry, it is a supervisory approach that takes into account any inspected firm's risk profile and as such attempts to be proportionate to the risks that the firm poses to the FSA's own statutory objectives¹¹ as assessed under the FSA's firm risk assessment framework.

So how does the UK agenda tie back to McCreevy's own comments, the EU's Green Paper, and the work being undertaken by CEBS on the CRD or the work of the Committee of European Securities Regulators (CESR) on MiFID and any further ideas around supervisory convergence? It appears that there is not an agreed set of criteria or objectives underpinning the 'better regulation' concept.

Stakeholders need more clarity. If a risk-based approach is to be adopted and evaluated against a series of objectives, surely these objectives must be spelt out and clearly communicated to all stakeholders. In the case of the financial services industry, are the FSA's statutory objectives an appropriate starting point for any EU discussion? Do they fit the requirements and concerns of all stakeholders? Would this approach put an end to (UK) gold-plating? Is regulation to be assessed with consideration given to a wider legislative context and will this help to reduce overlaps? Does simplification imply the adoption of a principles-based approach supported by the Lamfalussy process?¹² If so, how should we evaluate the work of the Lamfalussy Level 3 Committees?¹³ What does 'better regulation' imply for those firms taking a holistic approach to risk and the role of concepts such as SREP and RAS in informing any review of financial services legislation? How can any cost-benefit analysis estimate the benefits of an integrated European market? These are the type of questions that require a direct and clear response from the Commission and any other parties involved in creating 'better regulation' at the EU level.

I applaud the Commission's commitment to openness evidenced by the Commission's 18/07/2005 Exchange of Views on Financial Services Policy event. It may be one way to obtain a dialogue on these issues that balances the typical consultation process which can be subject to vested interests on both sides of the regulatory fence and/or unconsciously guided by the silo approach typically adopted by specialist practitioners who are not trained or encouraged to look outside their own box. The EU's Green Paper and its willingness to engage in an open and transparent discussion gives all market participants an opportunity to make their views formally known:

⁹ UK presidency runs from 01/05/2005 to 31/12/2005.

¹⁰ http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2005/press_50_05.cfm

¹¹ As identified under the FSA's 2003 *The firm risk assessment framework* these are maintaining market confidence, promoting public understanding, securing consumer protection and reducing the scope for financial crime (http://www.fsa.gov.uk/pubs/policy/bnr_firm-framework.pdf)

¹² For a description of this process see the final Lamfalussy process report - http://europa.eu.int/comm/internal_market/securities/docs/lamfalussy/wisemen/final-report-wisemen_en.pdf

¹³ That is CESR, CEBS and CEIOPS.



maybe it is time to take up the offer and urge the EU Commission to focus on defining the criteria and objectives underpinning the 'better regulation' concept.

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