

The following Compliance articles are for the week ending 8 May 2009.

COMMENTARY

FSA CALLS FOR MORE EFFECTIVE GOVERNANCE AND RISK MANAGEMENT AT FIRMS

On 7 May, FSA went out to re-stress to the regulated community the need for financial companies to create board-level governance structures that allow for challenge without creating conflict.

Addressing the Securities and Investments Institute, Hector Sants, CEO of the FSA outlined the changes being made in the regulator's approach to judging the competence of firms' senior management as well as their probity.

He said the economic crisis had demonstrated that "albeit with the benefit of hindsight, there are some management decisions that have revealed a degree of incompetence, and at times a rather cavalier approach regarding risk management. The necessary challenge was missing from governance structures, in particular boards, and there may well be questions that can reasonably be asked about the openness and thus, arguably, the integrity of firms dealings with regulators, shareholders and their customers."

But he added, "The structure of governance in financial companies does not need radical overhaul. The attitudes and competence of the individuals who conduct that governance does. In particular we need to create governance that fosters challenge without creating conflict. The effectiveness of governance is the key issue and addressing this challenge is the responsibility of all of us, not just regulators and boards." He stressed, however, that "this by no means weakens our fundamental view that firms' senior management carry primary responsibility for their actions and their resulting consequences."

The FSA is not seeking to establish non-executive directors as a competing governance mechanism against the executive. It is about making both much more effective.

The FSA therefore, continues to support the 'unitary board' model but, as Mr. Sants said "it must be recognized that such a structure runs the risk of encouraging the herd instinct both in the sense of encouraging 'follow the leader' behaviour and in the sense of the reluctance to 'break away from the pack' and express an independent view."

As part of the Significant Influence Function ("SIF") review, the FSA has introduced interviews for candidates for a number of the key functions in an authorised firm. The presumption is that any application submitted by a high impact firm for the roles of Chair, CEO, Finance Director or CRO/Risk Director will result in an interview. Other SIF candidates may also be interviewed at the supervisor's discretion.

In the first six months of the enhanced approval process, 51 SIF interviews were carried out. In a number of cases applications have been withdrawn following interviews which raised questions concerning the candidate's fitness and propriety.

The FSA published Consultation Paper 08/25 in December 2008 which outlines a number of proposed changes to significant influence controlled functions under the approved person regime. The FSA expects to publish a further statement on this alongside the Sir David Walker's Review of governance.

Source: FSA Website

SPEECH - REGULATOR'S ROLE IN JUDGING COMPETENCE

As part of his speech at the SII conference, in addition to the comments on risk and governance, Mr. Sants went on to give insight on the assessment of SIF (Significant Influence Function) competence in post.

This will be based around evidence to support the following areas:

- Knowledge: Does the individual have and use the generic knowledge of the sector and the specific knowledge of the firm necessary to fulfil the role?
- Skills: Does the individual demonstrate the business and interpersonal skills required to fulfil the role and to meet the required standards?
- Behaviour: Does the individual demonstrate the attitudes and standards of ethical behaviour required to fulfil their role?
- Expertise: Does the individual achieve positive and fair outcomes and meet the performance standards expected for the post?

Mr. Sants went on to remind the audience that FSA's approach did not detract from firms' responsibilities to ensure they have competent people at a senior level.

Source: FSA Website

DISCLOSURE OF CONTRACTS FOR DIFFERENCES

On 8 May FSA published a series of questions and answers to cover key issues which may assist market participants' understanding of the new regime.

Main topics covered are purpose & scope, calculating a disposable holding and Exemptions. These new rules come into force on 1 June 2009, although there will be a transitional period (for delta reporting) until 31 December 2009. The Q&As should be considered in conjunction with the relevant Consultation Papers and Policy Statement relating to the rules.

FSA explained that the new rules are being implemented in response to a number of market failures that are more widely discussed in Consultation Papers (CP) CP07/20 and CP08/17.

Persons interested in the policy debate behind the introduction of the new rules are advised to review these CPs and FSA's responses in the corresponding Policy Statement, PS09/3.

Source: FSA Website

COSTS AND BENEFITS OF REGULATION

As part of their Occasional Series of papers on matters of interest to the regulated community, FSA published on 7 May a document entitled "Cost and benefits of regulation in a market with consumer confusion".

The abstract states "Regulators intervene in markets to reduce 'consumer confusion'. Yet the net effect of such interventions is often unclear. This paper models theoretically the effect of regulation on a market where consumers are confused about prices.

It does not set out to examine all of the factors that may affect consumer behaviour. The theory suggests three things:

1. First, where entry to the market is very costly, regulation may improve consumer welfare, but in general the effect of regulation is ambiguous
2. Second, where firms can freely enter the market, the costs of regulation tend to exceed the benefits in the long run
3. Third, it is in consumers' interest for regulators to raise revenues using levies that are equal per firm rather than proportional to firm output

The paper concludes "This paper introduces costly regulations into a model of a market where consumers can easily see all prices being offered, but are prone to confusing what these prices actually mean.

The resulting model allows us to compare the costs and benefits of regulation in equilibrium, after firms have responded to the regulation by changing their prices and possibly entering or leaving the market. The model could assist regulators in determining which possible regulations would pass a cost-benefit test before imposing them. In particular, the model suggests regulators' consumer research should test, not whether consumers understand products in a binary (yes or no) sense, but rather for the distribution of consumers' errors in evaluating prices.

Whether regulation increases consumer welfare in this model is ambiguous overall and depends on the parameters of the particular case. Where costs of entry are low, however, it turns out to be hard for regulation to make consumers better off in the long run.

This is because the entry of new firms exerts a powerful downward influence on prices and produces the benefits of regulation without the costs.

This result supports the UK's philosophy towards consumer protection in financial markets, which relies more on the beneficial effects of market competition than the approach of other EU countries that rely more on regulation.

The paper also has implications for regulators' optimal use of levies to raise their required revenue. The model indicates that, from the perspective of consumer welfare, regulators should raise funds using fees that are not related to firm size.

The intuition is that fees related to firm size tend to discourage firms from attempting to undercut each others' prices, because they reduce the profit gained by increasing market share."

Source: FSA Website

STATEMENT ON LEHMAN-BACKED STRUCTURED PRODUCTS by FSA & FOS

On 7 May, FSA and FOS issued a statement jointly concluding that Lehman Brothers' insolvency raises issues in the UK structured products market.

As a result, while the Ombudsman has been investigating a number of individual complaints, the FSA has been actively looking at the wider issues raised in this market.

The FSA and Ombudsman have agreed that the regulatory options available to the FSA would be one way of reducing consumer detriment, as well as potentially being able to deal with the concerns of more consumers than those who have complained to the Ombudsman.

Therefore, they have agreed that the FSA will now consider issues relating to Lehman-backed structured products under the "wider implications" process in order to allow the FSA to explore all options to achieve the best outcome for consumers. The wider implications process is intended to provide a transparent means of bridging potential regulatory gaps or overlaps between the FSA, Ombudsman and Office of Fair Trading on 'significant issues', including those that may give rise to widespread consumer detriment

Source: FSA Website

FEEDBACK ON INSURANCE RISK MANAGEMENT: THE PATH TO SOLVENCY II

In a Feedback Statement published on 6 May, FSA summarised the comments received to their questions posed in the Discussion Paper (DP) on Insurance Risk Management: The Path to Solvency II, DP08/4.

DP08/4 was published in September 2008 with the objective of highlighting and explaining the key elements of the Solvency II regime, with the aim of stimulating and helping UK insurers' preparations.

The DP included a section on key messages for UK firms and each chapter highlighted the functions within firms that will need to be involved in implementing particular requirements.

Throughout the DP FSA raised questions on issues where specific feedback was sought, though stakeholders were invited to share their views on any of the matters addressed in it.

Since DP08/4 was published, the Solvency II Directive has been officially adopted. Although there have been some changes to the Directive through the co-decision process between the European Parliament and the Council, the key point to note is that the implementation date (stated in the Directive) for Solvency II will remain as 31 October, 2012.

It is essential for the UK insurance industry to fully engage now in preparing for the new Solvency II regime. If firms are yet to do so, senior management should consider now the implications for their business and start planning immediately to ensure compliance with the new rules.

Alongside the responses to comments received, FSA have provided in the FS an update to the messages in DP08/4 in light of the Solvency II Directive as adopted which should help firms with their implementation planning.

In Chapter 7 of the paper FSA provide details of plans with respect to forthcoming thematic reviews.

At a European level FSA have also included the Committee of European Insurance and Occupational Pension Supervisors consultation schedule for 2009, these being the Consultation Papers that have and are scheduled to be published on the advice to the European Commission on Level 2 implementing measures.

Source: FSA Website

REPORT ON FUTURE OF UK FINANCIAL SERVICES

The ABI has responded to the Sir Wim Bischoff/Chancellor Group report on the future of UK international financial services. The ABI's Chairman, Archie Kane, was a member of the group.

Commenting on the report, Peter Vipond, the ABI's Director of Regulation said: "This report contains many sensible and useful suggestions, which should help ensure the current banking crisis does not taint the benefits of financial services to consumers or the UK economy.

The report also recognises that regulators must not read across from issues in banking to other sections of the financial services sector, and regulation must not inhibit the ability of firms to offer competitive products for consumers. As the report says, we need 'responsible financial innovation with effective oversight'.

The goal of closer working by Government and industry to ensure more stable and effective systems of tax and regulation must be made a reality as soon as possible. This is something the insurance industry has long asked for, and already started, including meetings with the Chancellor.

This spirit of closer co-operation has already made a difference, with positive changes in the Budget over the taxation of foreign profits of UK domiciled firms. The changes to the pension's tax relief for higher rate taxpayers show there is still work needed to improve communication between industry and Government."

Source: ABI Website

FSA Events Monthly Update - May 2009

Please find below an outline of our spring and summer events programme.

Conferences

Mortgage Conference, 12 May 2009, Renaissance Chancery Court, London

This is a key opportunity for the FSA and the mortgage industry to work together to look at issues the market faces and consider plans for the future.

Seminars

Pension switching seminar for Compliance Consultants, 14 May 2009, Merryhill, Dudley

This seminar is for Consultants that provide compliance services to businesses that provide advice about pensions. This seminar is not aimed at in-house compliance officers. Please note that the London date (13 May) is fully booked.

Briefings

ARROW® II Breakfast Briefing - Ask the Regulator, various dates, London E14

This series of briefings may be of particular interest to firms who are preparing for an ARROW® II risk assessment. Limited to a maximum of 10 participants, this is your chance to ask the ARROW® II team straight questions and get straight answers on any aspect of ARROW® II.

Coming Soon

Asset Management Sector Conference, 17 September 2009, London

To register your interest in attending please e-mail claire.tatchley@fsa.gov.uk

Annual Public Meeting, 23 July 2009, London

Further information will be published on the events page shortly.

Insurance Sector Conference, Autumn 2009, London

For full details of the our events please visit: <http://www.fsa.gov.uk/Pages/Doing/Events/index.shtml>

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