

## Treasury Select Committee

### The Government's proposals for financial regulation

#### Memorandum by the Investment Management Association

1. The IMA represents the investment management industry in the UK. At the end of 2009, its members managed some £3.4 trillion of assets on behalf of a diverse range of clients including pension funds, life insurance companies, holders of retail investment products, sovereign wealth funds and others. We welcome the opportunity to contribute to the Committee's deliberations on this matter and would be pleased to supplement this note with oral evidence should that be of assistance to the Committee.
2. There is no absolute and definitively correct structure for financial regulation. All models have their pros and cons. We think however that there are merits to the model now proposed by the Government, in particular:
  - the separation of prudential and conduct of business regulation, which may sometimes be in conflict
  - bringing oversight of financial stability into closer proximity with the prudential regulation of individual banks.

Ultimately, however, how well the structure performs will depend on the talents and experience of the individuals charged with managing it. Getting this right will be the single most important challenge facing the Government in introducing these changes.

3. We welcome and support the proposal that the **prudential regulation of investment management firms should rest with the CPMA**. This recognises that the business model of an investment management business is radically different from that of a bank or an insurance company, in that it is agency-based rather than a principal model. Custody of client funds is completely separate from the manager, unlike banks and insurers where they are held on balance sheet. For this reason, prudential or solvency regulation of the sort required for banks and insurers is not necessary for investment managers.
4. We also agree strongly that the **CPMA should have oversight of all conduct of business regulation, both retail and wholesale**. The focus of prudential regulators is on the structure and solvency of the business itself. Prudential regulation does not as a matter of course concern itself with the detailed rules around the institution's dealings with its customers. A major problem in the conduct area can of course impact a firm's prudential situation – Equitable Life being a case in point – so that the prudential regulator will need to keep itself informed. But that is very different from carrying out the

supervision itself. It is significant that for many years banks were not subject to statutory regulation in respect of their dealings with customers, and it was only in recent years that the FSA began to take this on.

5. Keeping retail conduct regulation under one roof will also help to ensure that comparable rules are applied to different products which effectively compete with each other – for example funds, life insurance investment products and banking products. At the present time all are subject to different rules, although a forthcoming EU initiative will seek to address this. So long as this remains the case, there is a risk of consumer detriment.
6. Investment managers have a major interest in the integrity of capital markets. In aggregate, rewards for capital market intermediaries are at the expense of investors, most of whom are ultimately small retail clients, whether through pensions, ISAs or other channels. It is therefore essential that we have strong and effective regulation of capital markets to ensure that they operate openly and transparently and in the interests of issuers of capital and of end investors.
7. One necessary condition for an effective regulator is that it can see the whole picture. **We do not therefore support the suggestion that the UK Listing Authority be removed from the CPMA and combined with the Financial Reporting Council.** We do not believe it is sensible to separate primary from secondary regulation of the equity markets in this way. The continuing disclosures under the Listing Rules are an essential ingredient of a well functioning market, and to separate responsibility for them from responsibility for investigating market abuse would risk opening unwelcome gaps in regulation which could ultimately work to the disadvantage of investors.
8. Moreover, the FRC is not equipped to act as a market regulator. Its primary functions now are for standard setting and for oversight of professions. We do not think there is a logical fit between these and the duties of UKLA.
9. We attach responses to the questions listed in the Committee's call for evidence.

Investment Management Association  
22 September 2010

## IMA RESPONSES TO QUESTIONS POSED IN COMMITTEE'S CALL FOR EVIDENCE

### Overall

- 1. Will the Government's financial regulation proposals improve the framework for financial stability in the UK? Will they work in a crisis?*
- 2. Do the Government's proposals get the balance right between tackling the problems of the last crisis and preparing the UK financial system for the next one?*

Simply reassigning responsibilities will not of itself improve financial stability in the UK. What will be crucial going forward will be the quality of the individuals charged with responsibility for managing these institutions and the effectiveness with which they co-operate.

To the extent that the regulation of banking is brought closer to financial policy, that may help to ensure effective communication during and planning for crisis. But at the root of the credit crisis was a widespread failure by market participants, regulators and policymakers to appreciate the risks that the system was running and its vulnerability to any loss of confidence. That is not and cannot be addressed simply by institutional change such as these.

- 3. How do the Government's proposals dovetail with initiatives currently being undertaken at European and the global level?*

The Financial Policy Committee's responsibilities will to an extent map across to those of the new European Systemic Risk Board. The structure of supervision will however be different. There will be three authorities dealing with prudential regulation, not just the CPMA and PRA as proposed in the UK. More significantly perhaps, in the UK conduct of business regulation will all be carried out by the CPMA, whereas each of the three EU supervisory authorities will have responsibility in their sector.

The UK model is undoubtedly to be preferred, since it should in principle ensure a more consistent outcome as between banking, insurance and investment products. This will in turn be likely to secure better outcomes for consumers since there will be less scope for regulatory arbitrage between products and it will be easier for them to compare different types of product. But it will present challenges for the CPMA in that, while its primary relationship will be with the European Securities and Markets Authority, it will also have to deal with the banking and insurance authorities. It may need to seek the aid of the PRA in developing and maintaining those relationships.

- 4. What costs will the regulatory structure place on consumers?*

We can see no reason why the costs of this structure need be greater than those of the FSA. There should therefore be no extra costs for which there might be a risk of being passed to consumers. In particular, these changes imply no need for major changes to existing supervisory rules. As already indicated the "horizontal" conduct supervision under the CPMA can be expected to work in the interests of consumers. See also our response to question 15 below.

### **Power, roles and responsibilities**

5. *Do the Government's proposals appropriately assign roles and responsibilities between the different regulatory institutions?*
6. *Will there be unintended consequences of the Government's proposals for regulation on the prospects for non-bank financial institutions?*

Whilst we consider the broad architecture to be a matter for the Government; the positioning of asset managers with the CPMA for all purposes is welcome. We would trust that the FPC will not communicate solely with the PRA and would trust that buy side and savers' views will be captured in its considerations. There is a technical issue over many asset managers having an investment-only captured insurance company as a subsidiary for wrapping some products in an insurance contract. In theory these would have to be regulated by PRA on the current proposals, which would seem unnecessary duplication, and a *de minimis* approach would be appropriate.

We consider that responsibility for primary market supervision is intimately connected with that for secondary markets. The UK listing rules require listed companies to make a wide range of disclosures which are designed to ensure the functioning of an orderly market. We think it would be unwise to separate these responsibilities from those for policing market abuse. The proposals already put one aspect of market regulation (clearing and settlement) with the Bank of England. Splitting the UK Listing Authority from the CPMA would spread market regulation across three different authorities. That would risk a less joined-up approach to market supervision, and a greater danger of market abuse. We would not therefore support the option canvassed in the Treasury consultation paper of combining UKLA with the FRC under a new companies regulator.

### **The Financial Policy Committee (FPC)**

7. *Should the FPC have a statutory remit? If so, what should that remit be?*
8. *How should the success of the FPC, both in and out of crisis, be measured?*
9. *Given the international regulatory framework, what macro-prudential tools should be granted to the FPC?*
10. *Has enough been done to mitigate the risk of conflict between the FPC and the Monetary Policy Committee (MPC)? Is the FPC appropriately structured in terms of:*

- a. *The balance between internal and external members?*
- b. *The size of the Committee?*

11. *What characteristics, experience and qualities should the Government look for when appointing external members of the FPC?*

See our comments above in response to question 6.

### **The Prudential Regulation Authority (PRA)**

12. *Should the PRA be the lead authority over the Consumer Protection and Markets Authority (CPMA)?*

We do not consider that the PRA should be seen as the lead authority over the CPMA. The high level proposals from HM Treasury do suggest a hierarchy, especially on the need to consult or inform about decisions: the CPMA is required to communicate with the PRA, whereas there is little or no obligation the other way round. In practice the concerns would be:

- Different supervisory approaches or interpretations of identical EU-derived obligations;
- A suggestion that some consumer redress or protection might be compromised or postponed so as not to cause or exacerbate a prudential issue. This might include proper disclosures by banks or issuers as well as more common consumer redress issues. In our view the CPMA should be able to make its judgements unfettered by prudential concerns
- Prudential approaches becoming dominated by the PRA (when its responsibility will not encompass by number the majority of prudentially supervised firms and when the CPMA-supervised firms should rightly be subject to prudential rules appropriate to their business models);
- The maintenance of extra resource at the PRA so as to shadow and comment upon CPMA consultations in the arena.
- Internationally an appearance that a second level regulator was dealing with key issues such as in markets and a variety of Directive proposals such as for Packaged Retail Investment Products.

13. *Is it appropriate for the PRA (and CPMA) to adopt a judgements-based approach to financial regulation and supervision?*

In principle, we believe this would be appropriate, both for the PRA and the CPMA. The credit crisis in part arose because of a too ready acceptance by regulators globally of business models that turned out to be unsustainable and destabilising. Equally, the IMA supports the FSA's recent statement about its more intrusive "upstream" approach to retail conduct – products have been sold to consumers in recent years which should never have come to market.

But great caution needs to be applied to such an approach. It must not turn into systematic second-guessing of decisions taken by regulated firms, which in turn becomes an inhibitor of legitimate innovation. The key to this will be to ensure

that only staff with the highest levels of skills, training and experience – including experience in the industry – are entrusted with such judgements.

The Financial Services Practitioner Panel and Small Business Practitioner Panel have proven a valuable source of advice and counsel to the FSA. The Government propose that these should continue in existence for the CPMA but not for the PRA. We do not understand the reasons for this proposal, and consider that the PRA could benefit from practitioner input in the same way that the FSA has.

### **The Consumer Protection and Markets Authority (CPMA)**

#### *14. Do the reforms provide adequate protection for the consumer?*

Ensuring the objectives of the CPMA are rightly described is important; but an early appointment of the senior management team will be critical in setting the right culture for the CPMA.

Of necessity, the objectives will always be drawn at a high and wide level to avoid any lacuna in powers. Beyond descriptions of the CPMA as a consumer champion, the consultation does not address whether the CPMA will need (as FSA does) to have regard to the principle that a consumer should take responsibility for his own decisions, in considering what degree of protection may be appropriate. This issue, of consumer responsibility, has remained intractable despite the previous FSA chairman's struggle. In ensuring consumers are championed, we suggest that this should be seen as ensuring they have a better deal, and not simply, better protection. Disclosure, suitability and fairness must all be considered by the CPMA but the context must not be that consumers have no responsibility for their decisions - that would perpetuate a moral hazard in our system. We do support the continued existence of FOS and the FSCS.

#### *15. To what extent will the regulatory and administrative burden increase for those firms who now have to deal with two regulators?*

We consider that the benefits, particularly for consumers, of "horizontal" regulation of conduct of business by the CPMA will outweigh any costs arising from some firms having to face two regulators. In contrast if the conduct supervision of banks and insurers were undertaken by the PRA, there would be significant fissure in consumer protection matters. In general prudential supervisors are not equipped to carry on conduct or investor protection supervision.

### **Other issues**

#### *16. Should any of the proposed bodies be given responsibility for promoting competition in the banking and financial services sector?*

*17. Should any of the proposed bodies have a role in promoting the City of London?*

It is not the role of regulators to take on a promotional function. It is important that the new bodies should have a duty to have regard to international competitiveness in carrying out their duties, as the FSA does today. But that is very different from a role of positively promoting the UK financial services sector. That is properly a matter for Government to ensure a legal and regulatory environment which is conducive to the growth of a healthy sector, and for the sector itself, though bodies such as TheCityUK.