



Response from the Association of Independent Financial Advisers to FSA Discussion Paper 09/2 – A regulatory response to the global banking crisis

Introduction

The Association of Independent Financial Advisers (AIFA) is the trade association that represents independent financial advisers (IFAs). Under the AIFA umbrella we also represent mortgage intermediaries through our subsidiary association the Association of Mortgage Intermediaries (AMI). AIFA currently represents over 75% of IFA firms in the UK.

The IFA sector is the dominant distribution channel for retail financial products generating over 63% in monetary value in 2005. The sector is particularly strong in the private pensions market, generating 77% (in monetary value), of all pension and annuity business in 2005. As such, IFAs are extremely important in helping to meet government objectives by encouraging self-provision and increasing personal wealth.

Any regulatory impositions that threaten the survival of the sector need to be considered in light of the undesirable impact that a significant reduction in IFA firms will have on consumers and government policies. It is pleasing to note that this is recognised by John Tiner, former-FSA Chief Executive in his speech on 14th June 2006, when he commented: *“... in terms of efficient markets, I do think we have a legitimate interest in ensuring that we have an intermediary sector that reaches as many consumers as possible; that offers quality advice to those consumers; and that is sustainable in the long-run.”*

AIFA welcomes and supports the intentions of the recent Turner Review and the accompanying discussion paper. The events of the past 18 months demonstrate there needs to be careful consideration of financial regulation both at national and at European level. While there is a certain degree of shutting the stable door after the horse has bolted, we do believe that it was essential that the root causes of the system issues were identified so suitable responses could be developed; we support the analysis behind the Turner Review. We now need a system which has increased accountability, increased transparency, delivers in a cost-effective way and which ultimately works better for firms and the clients they serve.

We recognise that regulatory developments are moving at a very fast pace, particularly in Europe where the Larosière proposals are already being implemented. FSA therefore needs to ensure it works with, not against, the current move of change at the European level. Further, we believe FSA

should be working with Treasury colleagues in ensuring that the changes developed at European level benefit the UK's financial services market, as we perceive a significant risk of change leading to a weakening of the UK's competitive position. We also recognise it is impossible to achieve a zero failure regime and the focus should therefore be on minimising the risk of economic collapse and limiting any contagion.

The comments in this response follow consultation and research with AIFA members. This research shows there is strong support for a stable regulatory regime. We do not see amendments to the current regulatory architecture as being good per-se. Members clearly wish to see a regulatory structure that:

- Changes less, with fewer “new ideas” and more consistency of delivery
- All proposals to be subject to greater scrutiny and cost benefit analysis before announcement
- Recognises that UK consumers have borne the costs of change – but seen the savings gap grow, levels of personal debt increase, and numbers of advisers fall
- Seeks to work with the sector; recognising the good in firms rather than assuming the worst

Members were also concerned about the “politicisation” of regulation and wished to see a structure emerge that guaranteed the independence of the bodies involved, rather as the Bank of England had gained in interest rate setting.

Executive summary

Macro-prudential policy

A crucial failure of the years running up to the crisis was the failure to realise and take action against growing systemic risk. This failure was evident throughout the regulatory system in the UK:

- The Bank of England (BoE) focused on monetary policy analysis and underemphasised its systemic scrutiny role.
- It is acknowledged by FSA themselves that they focused too much on the supervision of individual institutions, and insufficiently on the wider sectoral and system-wide risks.
- The vital activity of macro-prudential analysis, and the definitions and use of macro-prudential tools, fell between two stools. The problem was not “overlap” but “underlap”.

It is therefore clear a new framework for macro-prudential policy is needed in order to avoid another economic crisis. The experience of the past 18 months has demonstrated that the current prudential framework is far too focused on the micro-prudential objective of ensuring that each individual bank is

adequately capitalised, and has failed to address the systemic risk that has accumulated across the financial system as a whole.

Macro-prudential policy needs to reduce the risk of a systemic financial crisis occurring, and limit the damage it would cause. We therefore believe there appears to be some merit in calls for a single body to have overall responsibility for this role, members suggested that the Bank of England “be re-banked” and take over macro-prudential and financial stability regulation. This could help to ensure the financial system is not again allowed to become dangerously over-leveraged, providing the BoE is given greater expertise and discretion, and the power to make judgments about the sustainability of debt.

If FSA is to retain this macro-prudential role then greater coordination with the BoE is clearly necessary. A body needs to be created in which the two organisations can come together to debate macro-prudential analyses and decide on the actions needed. We agree with the Turner Review that any new structure must recognise the particular insights that supervisors bring to the macro-prudential debate, as well as the macroeconomic perspective where central banks have the natural comparative advantage due to their role as monetary policymaker. We agree with Mervyn King’s assessment that a body without power will be reduced to “preaching sermons and organising funerals”

Part of managing the overall systemic risk in the economy is ensuring that the largest, systemically significant banks are subject to robust prudential regulation which deals with the problems of the economic cycle and with liquidity risk. However there also needs to be careful consideration of both the costs and benefits of any proposals.

AIFA believes that the prudential requirements for firms should be defined by the broad parameters:

- Counter-cyclical
- Risk-related
- Robust and residual

AIFA agrees with the Turner Review that ‘counter-cyclical’ capital requirements be developed, allowing firms to accrue capital during good times which crucially can be *used* during periods of difficulty. This would allow firms far greater flexibility and would potentially create a more robust market.

We also think it is crucial that prudential requirements are risk-related, with the regulator differentiating between different types of institutions and the level of systemic risk they pose. For example, IFA firms pose no systemic risk and should therefore not face the same prudential reforms applied to large, risky banks.

Additionally it is important that prudential reform should not come at the expense of consumers. FSA need to take into consideration the consequences of increasing requirements for banks which undertake significant business in retail or commercial banking, as the risks of cross-

infection and potential for taxpayer intervention would require significant levels of capital to offset them.

Another key issue that should be taken into consideration is that of potentially creating an uncompetitive UK regulatory regime. FSA needs to minimise the risk of businesses deciding to operate offshore or through off balance sheet vehicles purely to avoid heavy UK capital requirements.

Finally, it is suggested that the “regulatory gateway” be formally reviewed in order to ensure that the current level of scrutiny is correct for firms applying for authorisation. Any firm’s business plan must take account of the factors above; and those seeking to run the firm must be of sufficient caliber to manage the firm through both good, and bad, parts of the cycle. Those who are found weak in either aspect should not be allowed to risk either the sector’s reputation, or more importantly, consumer’s funds.

Responding to events – international architecture

We need to aim for a world where better corporate governance and better-informed shareholders reduce unnecessary risk, increase stability and restore consumer confidence. In such a world uneconomic levels of regulatory capital should not be needed and economic growth will be less inhibited.

Regulation and supervision must therefore be of better quality at national level, but also work across borders. Members suggested that the world does not need a global supervisor of national markets. Such a body would be too remote from national problems and too bureaucratic. But some things can only be done through international cooperation, as the G20 has aimed to do. We need concentric rather than overlapping circles of regulation; international, European and national, with each concentrating on their strengths and ceding responsibility to those in the best position to act, rather than duplicating or frustrating such action.

AIFA believe that the world's monetary authorities and its regulatory and supervisory financial authorities can, and must, do more to reduce the chances of crisis events happening again.

Good regulation should concentrate on the major sources of weaknesses; dealing with financial bubbles, strengthening regulatory oversight on institutions that have proven to be poorly regulated, adapting regulatory and accounting practices that have aggravated pro-cyclicality, promoting correct incentives to good governance and transparency, ensuring international consistency in standards and rules, as well as much stronger coordination between regulators and supervisors. Over-regulation, however, should be avoided. It slows down financial innovation and thereby undermines economic growth in the wider economy. The effect of the Sarbanes-Oxley Act in the US provides a good example of why over-regulation can be a detrimental move, damaging a country’s competitive edge and driving business away elsewhere.

We are not saying that all crises can be prevented in the future, and recognise a zero-failure regime is undesirable. What could and should be prevented is the kind of systemic and inter-connected vulnerabilities we have seen and which have carried such contagious effects.

The global financial system as we know it was forged by deregulation and underpinned by a belief in free markets. That approach failed due to the much-commented upon “over exuberance” of market participants – and the laissez-faire attitudes of policymakers. The task now is to ensure markets can be unfrozen and confidence restored with more appropriate restraints and guidance.

At a European level members supported many of the proposals put forward by the Larosière Report, many of which are already in the process of being implemented. In particular we welcome the creation of a European Systemic Risk Council (ESRC) and the G20 conclusion to reinforce the role of the Financial Stability Forum as it becomes the Financial Stability Board. As the stability issues are global, a good coordination between the two bodies will be essential

We also strongly support the strengthening of the three Level 3 Committees (CEBS, CEIOPS and CESR) and their transformation into European Authorities (European Banking Authority, European Insurance Authority and European Securities Authority) as suggested in the Larosière Report.

The three Committees appear to have reached their limits, in terms of both resources and also legal powers. It is therefore logical and practical to strengthen the Committees by giving them real powers, while leaving day-to-day supervision to national supervisors, thus making full use of their local knowledge.

In terms of supervision the prime objective is to ensure that the rules applicable to the financial sector are adequately implemented. In turn this will preserve financial stability, ensure confidence in the financial system and secure sufficient protection for the customers of financial services.

Supervision should aim to encourage the smooth functioning of the markets and the development of a competitive industry. Poor supervisory organisation or unduly intrusive supervisory rules and practices will translate into costs for the financial sector and, in turn, consumers. Supervision should be carried-out as effectively as possible and at the lowest possible cost. At the height of the financial crisis information flow amongst supervisors was far from being optimal, systemic risk therefore went relatively unnoticed.

A proposal outlined to address this is an atomised approach in which we see much merit. In addition to a split between Conduct of Business (COBS) and Prudential, members tell us that they wish to see greater focus on like-for-like businesses so that expertise can be developed, understanding deepened, and appropriate supervision take place. The current regulatory approach has been shown, on occasion, to fail to take a sufficiently deep view of practices to

unearth real issues. To draw from history: depolarisation and much of the focus of the Retail Distribution Review, have focused on “intermediation” while failing to recognise the economic model and practices of manufacturing firms were at least as worthy of review. Alternatively, the (very good work of the) retail intermediaries team does not span all forms of retail distribution, thus the regulatory standard between, for instance banking distribution and intermediary distribution may differ; leading to sub-optimal consumer outcomes. Thus, we favour a review of the current “groupings” with FSA to ensure their suitability for today’s market.

A failing of the current regime which was highlighted by the collapse of the Icelandic banks is in the area of branch passporting. A major problem is that the current passporting model is flawed as it assumes other regulators in Europe operate a similar standard and have practices similar to FSA. However the danger of overreacting to the single case of the Icelandic banks is that firms are encouraged to move offshore and operate back into the UK via passporting due to the uncompetitive regulatory burdens placed on them by FSA. Feedback from IFA firms indicates they would prefer to remain within a UK regulatory system and that ideally there should be no way of circumventing these standards to a perceived lighter regime. However, if competitors did operate via passporting and gained competitive advantage then firms may have no choice but to follow the same path. AIFA is therefore in favour of a level playing field across the EU to avoid this situation occurring.

We are also strongly against proposals for an EU wide pre-funded deposit guarantee scheme as we fail to see the benefit it would provide. It is merely another regulatory and cost burden on firms but more importantly is uncompetitive. Additionally if this scheme had been in place before the current crisis, it would still have had little or no effect on the problems experienced. We believe work on Leaving Resources Behind (LRB) has more merit as a means of protecting consumers and is likely to have a positive impact on FSCS levy-payer detriment. This is an issue AIFA has questioned members on, with 74% of firms in favour of the concept, or in need of further details. Only 26% of firms were against the proposals, and we therefore urge FSA to pursue this concept. Clearly as a ‘new concept’ an element of education and dialogue with the industry would be required, which AIFA would be happy to facilitate.

BoE Governor Mervyn King’s recent proposals for any regulated bank to have orderly wind-down plans also carry much merit. These plans would provide useful information to the authorities, the absence of which made past decisions about the future of institutions difficult.

With the ever increasing political and public pressure to “reinvent” the current UK and indeed global regulatory structure, it is inevitable that we will see significant changes to the existing regulatory landscape over the coming years. However, appropriate implementation of existing regulation, and better supervision, can often be more effective than new regulatory structures as these, in of themselves, do not lead to better outcomes for firms or consumers. This can only be achieved by setting clear regulatory objectives,

which are consistent and focused on protecting the consumer, not from his or her poor decisions but from unscrupulous market participants.

Scope of regulation and implications for other regulated sectors

AIFA's main concern regarding the regulatory response to the banking crisis is that independent financial advice is not banking and should therefore not be regulated in the same way.

Some of the largest IFA networks are owned by insurance companies and FSA should be wary of potential unintended consequences of banking regulation on other industries.

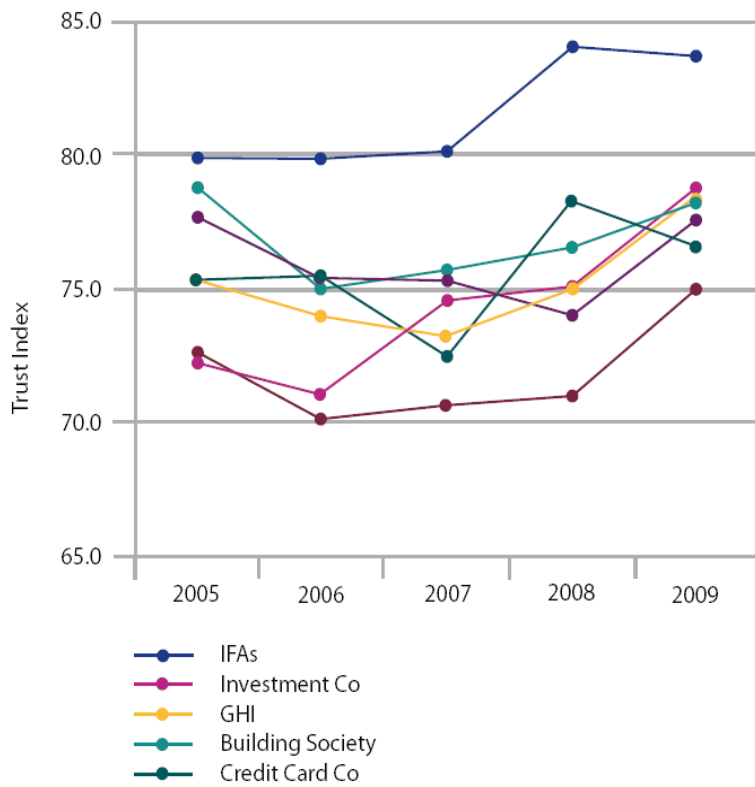
While we recognise that significant changes to financial regulation are necessary, IFAs were not the cause of the credit crunch, nor did they pose any systemic risk to the economy. It is therefore important that the response to the crisis does not extend the scope of regulation to activities that were not related to the causes of the crisis and have little systemic impact.

We want regulatory changes to focus on the banking sector which is where the major problems stemmed from, rather than apply a one-size-fits-all set of remedies to the entire financial services industry.

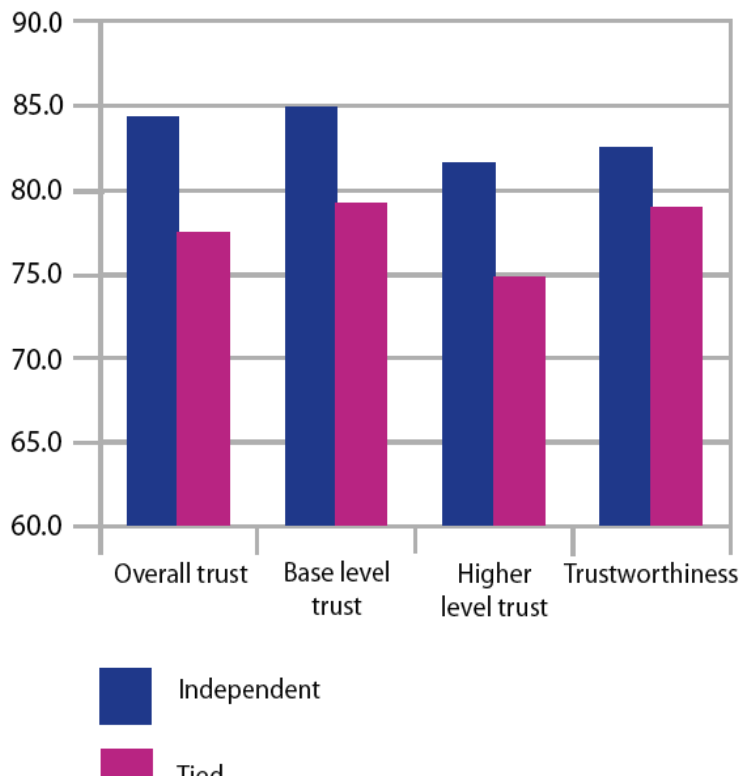
IFAs are not banks. Introducing simplistic measures, designed to prevent another banking crisis could cause major damage to an important industry, causing significant consumer detriment in the process by limiting access to financial advice. The IFA profession wants and needs regulation which is relevant to our sector, not regulation aimed at banks which has an automatic read-across. In particular AIFA does not wish to see IFA firms face new restrictions or regulation where there is no systemic risk.

Unlike all other parts of the sector, the public's trust and confidence in IFAs goes from strength to strength. Independent research from Nottingham University Business School on behalf of the Financial Services Research Forum shows IFAs have consistently been the most trusted FSIs since the Index was established. In addition the ratings for independent advisers are higher than those who are tied. The fact that trust for IFAs has remained high over the past 18 months is no mean feat when the financial services industry is facing some of the worst economic conditions seen and is hardly out of the media's glare.

Base Level Trust Over Time



Trust by Broker Status



(Source: The Financial Services Trust Index 2009, University of Nottingham)

Government and the regulator should build on this high level of trust in IFAs. If regulatory policy is to help the public have the confidence to re-engage with their long-term financial well-being, it should build on that which already works. AIFA believes that in this way, trust and confidence in retail financial services will be restored and, as a valuable by-product, the regulator's current aspirations set out in the Retail Distribution Review (RDR) will be delivered.

The intensive supervision model is also too much for firms of our nature. AIFA wants to work constructively with FSA to develop a model suitable for the IFA industry to be implemented when the enhanced supervision strategy comes to an end. FSA has invited our thoughts on the issue and we look forward to engaging with them on this topic.

Conclusion

There has clearly been a significant pressure placed on Government and the regulator to answer questions raised by the current economic crisis. The detailed report from Turner provides a good analysis of the cause of the crisis, and raises a number of important issues for discussion.

However AIFA would caution against the rushed implementation of additional regulation, and we are always wary of unintended consequences caused by such reactionary measures. We caution that in a global profession we should not underestimate the impact and consequences of altering capital and regulatory requirements for the banking sector.

If capital requirements are to be reformed AIFA strongly believes that they should be risk-rated, with reduced capital resources acting as a regulatory dividend for good firms. We believe good behaviour should be rewarded and AIFA is happy to work with FSA in terms of framing what firms would need to do to qualify.

As stated in previous AIFA responses, we encourage the regulator to consider the concept of a 'Regulatory Dashboard' of positive and negative risk indicators, tied to regulatory dividends for good firms. These could be monetary, or non-monetary, but could include capital resources. We would be happy to share our work on this model with FSA, and believe it is a positive way for FSA to work with the sector, in an open and transparent way, to frame their supervisory indicators.

FSA Chief Executive Hector Sants himself commented in a March speech that FSA had been too focused on policies and not enough on outcomes. We agree with Sants that to judge firms on the outcomes and the consequences of their actions not on the compliance with any given individual rule is a better way of regulation, which is likely to yield more positive results. Hence why AIFA is proposing dividends and a regulatory dashboard as a means to help achieve these outcomes.

AIFA has its concerns an overly robust regulator may risk stifling an economic recovery and creativity in the financial markets. We should be particularly mindful of introducing reforms in this country without agreement and consensus at both a European and global level. Without this the financial services industry in the UK could be placed at a real competitive disadvantage.

The real impetus for this review is to increase the regulatory overview of the banks where there is the greatest systemic risk. However, FSA must be mindful that any regulatory changes do not adversely affect other sectors of the industry.

Specific questions

Section 5: Macro-prudential policy

Q8: Should these reforms be applied to smaller and domestic banks, building societies and investment firms? If so, how can this be achieved in a proportionate manner?

When considering macro-prudential policy, FSA should consider the level of systemic risk the firm poses to the economy. IFA firms are not banks and should not be regulated as such. The risks presented by IFA firms do not therefore warrant the imposition of the detailed proposals for the banking industry contained within the discussion paper.

Q9: Do you agree with the FSA's reasons for favouring a range of policy measures to deal with macro-prudential policy issues rather than adjusting the Basel II risk-based capital requirement?

AIFA agrees with those measures which help to increase the robustness of the banking industry. However it is important these measures are both proportionate and work in consumers' best interests. Any FSA proposals need to work in conjunction with European and global regulation, and they must ensure the competitiveness of the UK financial system is not damaged as a result.

We suggest that the lessons learnt from Basel II are applied in how Solvency II is implemented both in the UK and across Europe. We would like to see FSA take the lead, working with colleagues at Treasury, to raise concerns if it seems that pro-cyclical results will occur from its adoption.

Section 7: Systemically important firms

Q22: What are your views on the balance between varying the intensity of supervision according to the impact and risk that an individual firm poses, and having policy frameworks and approaches that differentiate across-the-board according to a firm's systemic significance?

AIFA fully supports a supervisory regime which is based on the level of systemic risk posed by the individual firm. We do not wish to see the same standard and intensity of supervision applied universally across the financial services industry regardless of a firm's systemic significance. Supervision needs to be appropriate and proportionate. The intensive supervision model is too much for IFA firms. AIFA wants to work constructively with FSA to develop a model suitable for the IFA industry to be implemented when the enhanced supervision strategy comes to an end.

It would seem appropriate that the "impact / probability / risk" approach is now reviewed as it demonstrably failed in the regulation of banks. We would suggest that both an international study of regulatory practice is undertaken, along with an academic study of the latest in supervisory thinking. It would seem appropriate to suggest that this is the moment to look for new regulatory tools for future use.

Just as behavioural psychology is changing the way in which the regulatory authorities should approach consumers' attitude to (and interactions with) the financial services market, so new approaches are needed to the regulation and supervision of firms. For instance, in terms of regulatory philosophy, should the FSA be more like OfCom (which has presided over the mobile telecommunications boom and introduction of 3G licenses) or see itself as a utility regulator? It may be appropriate to adopt different cultural approaches between areas of regulation.

Section 9: Responding to events – international architecture

Q25: How can the international architecture be arranged to provide the most effective early warning of threats to financial stability and challenge to national authorities and in an apolitical way?

We support many of the proposals put forward by the Larosière Report, many of which are already in the process of being implemented. In particular we welcome the creation of a European Systemic Risk Council (ESRC) and the G20 conclusion to reinforce the role of the Financial Stability Forum as it becomes the Financial Stability Board. As the stability issues are global, a good coordination between the two bodies will be essential

Q27: Do these options represent the right approach to the problems posed by EEA branching?

The current passporting model is flawed as it assumes other regulators in Europe are as good as FSA. However the danger of overreacting to the single case of the Icelandic banks is that firms are encouraged to move offshore and operate back into the UK via passporting due to the uncompetitive regulatory burdens placed on them by FSA.

Feedback from IFA firms indicates they would prefer to remain within a UK regulatory system and that ideally there should be no way of circumventing these standards to a perceived lighter regime. However, if competitors did operate via passporting and gained competitive advantage then firms may have no choice but to follow the same path. AIFA is therefore in favour of a level playing field across the EU to avoid this situation occurring.

Q28: Are the functions of rule-making capability and supervisory oversight the right ones to be given to a European institution that has the characteristics described here?

We strongly support the strengthening of the three Level 3 Committees (CEBS, CEIOPS and CESR) and their transformation into European Authorities (European Banking Authority, European Insurance Authority and European Securities Authority) as suggested in the Larosière Report.

Section 13: Implications for other regulated sectors

Q37: Which of the issues set out for discussion in this DP are most relevant to other regulated sectors?

Many of the issues discussed in this paper are relevant as due to the global and interlinked nature of financial services, changes to the banking sector will have intended and unintended consequences on other regulated sectors, including the IFA profession. In particular macro-prudential reform and the international architecture will have a direct effect on IFA firms.

However, we would argue that the impact on the consumer must take precedence and must be understood before new regulatory proposals are introduced. This concern falls into two distinct areas:

- The direct impact. What will the changes in the market mean for consumers and their ability to access the best financial services can offer them. Will the proposals address the current imbalance in savings and debt? What will any proposals mean for the financial burden on firms – which is ultimately met by consumers?
- The indirect impact. Are firms more likely to stay in the UK or offshore? Will they lead to a more or less competitive market? Will more or fewer firms be attracted to the market? How easy will it be to attract new investors and sources of capital?

While we would counsel that a full Market Failure Analysis is conducted per sector, it is essential that the true and deep understanding of cost / benefits is known ahead of implementation.

AIFA
22.06.09