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The Financial Services Authority

Regulator, heal thyself

Teething troubles at Britain's financial regulator

TO BE effective, a financial regulator needs three things: a sound operating structure; sensible procedures and competent staff; and credibility so that wrongdoers are properly punished and others deterred. There are worrying signs that the Financial Services Authority (FSA), now Britain's only financial regulator, is falling short on the latter two counts.

This week an independent tribunal made stinging criticisms of the agency's handling of a case involving the alleged mis-selling of endowment mortgages by Legal & General, a big insurer (see page 69). While accepting the FSA's verdict that there had been mis-selling, the tribunal nevertheless lambasted the way the regulator reached its decision to fine the insurer £1.1m ($1.9m). This embarrassing ruling came only weeks after the FSA reached a settlement over a long-running scandal involving so-called split capital investment trusts. Consumers lost more than £600m on funds that were sold as low risk, then turned out be high risk. After months of obstructing the regulator, 18 banks and brokers agreed to pay a modest £194m in compensation, but admitted no guilt.

These cases have put the FSA on the back foot. There have been calls for its chairman and chief executive to resign or be sacked by the government. There have been suggestions that the whole idea of creating a single financial regulator is flawed and that a few specialist agencies would do a better overall job. Voices in the City of London are even muttering about the FSA's regulatory regime becoming a handicap that might allow rival financial centres to steal business.

All of these should be ignored, for now. The FSA is a young body that deserves more time to sort out what probably amount to teething, rather than fundamental, problems. Its full unitary powers came into force only this month, and it is far too early to condemn the effort to bring together once disparate regulatory functions under a single umbrella. That combination has been difficult, and it has mostly been done well. But this does not mean the FSA should be complacent. It has serious failings that it must address.

Start with its procedures. These seem inadequate. The tribunal this week pointed out that the case against Legal & General relied on too little evidence and included arbitrary changes of position. That is damning: a regulator cannot use flawed procedures without destroying its effectiveness. Similarly, the FSA relies on continuous monitoring of financial-services companies to keep it informed and allow it to issue warnings when necessary. If the monitoring is poorly constructed, as many argue it is, then the FSA will find itself struggling. Big investment banks claim, with some justification, that their risk-taking is unnecessarily micro-managed by the FSA, which should focus more on the systemic implications of one of them going bust. By contrast, the long-term balance-sheet risks being run by big providers of retail products, including life insurers, are not monitored closely enough. The same is true of the increasingly complicated products they sell to (often ignorant) consumers. The FSA's bosses need to make sensible changes in both disciplinary and monitoring procedures and then explain clearly what the new rules are.

Getting it right

The question of competence is more complex. It would be too harsh to conclude that the FSA is incompetent. But it cannot escape a problem faced by many regulators: that the salaries which it can offer are much lower than those offered by the industry it oversees, meaning that the top talent is usually on the other side. The agency's sharpest critics say it has plenty of staff but an insufficient aggregate IQ. The jibe hurts because, in an era of highly complex financial engineering, it has an element of truth. Over time, however, the regulator's staff will learn. And better procedures will make the FSA's competence (or lack of it) more evident. The long-term trick will be to retain good staff so that they can apply their knowledge to protect consumers and markets over long periods. That might mean introducing tighter rules on transferring from the FSA to jobs with regulated firms, something its founding boss and a head of enforcement have done with alarming speed.

But the biggest challenge for the FSA is to establish the credibility it currently lacks, and urgently needs in order to serve the public interest. If it genuinely tackles the kind of problems that initially dog any big project, then there are still good reasons to believe that the bold experiment of creating a unitary financial regulator in London will be judged a success, perhaps even by those it is regulating. ■

City regulation

Mud on both faces

Britain's FSA and the firms it regulates need to clean up their act

LEGAL & GENERAL (L&G), a big British insurer, has been quick to declare victory over its regulator. On January 18th, the independent tribunal that hears appeals against enforcement decisions by the Financial Services Authority cleared the company of the widespread mis-selling of mortgage-linked endowment policies that the FSA had punished with a £1.1m ($1.9m) fine. But mis-selling on any scale is bad; and the Financial Services and Markets Tribunal did find L&G guilty of some.

The case is one of many thrown up by the bear market in shares in Britain from late 1999 to early 2003. During the years of heady share-price growth that preceded it, individuals were inspired to buy endowment policies intended to pay off their mortgages at maturity. Many were not sufficiently warned that share prices fall as well as rise, and that investment performance might not be good enough to pay off the debt. Several large firms have been fined for mis-selling endowments, although L&G is the only one to have challenged the FSA. David Prosser, L&G's boss, took a risk, and although his company did not escape unscathed, he has reason to be pleased with the result.

The regulators emerge with the blacker eye in part because this is not their only recent mishap. On December 24th, the FSA announced details of a settlement in which the sellers of "split-capital" investment trusts (closed-end funds with several classes of shares) agreed to pay £194m to investors who had not been properly warned of the risks and management methods. As the regulators had indicated earlier that they were seeking some £350m, they were publicly bashed for not getting it. This week, the revelation that the Bank of England was boosting the number of staff devoted to sniffing out bad practices in the City suggested that it did not think the FSA was doing all that it could.

At issue is whether the FSA, which regulates the most sophisticated financial markets in Europe, is up to the job. This matters, not least because the European Union is moving quickly towards defining the shape of pan-European financial regulation and this, once set, will be hard to change. It matters too because the FSA has recently added to its enormous portfolio two more whoppers: mortgages and non-life insurance.

In its roughly five-year existence the FSA has achieved an enormous amount just by bringing Britain's formerly fragmented system of financial regulation under a single roof. But there are flaws, and the L&G case has highlighted them.

Procedurally, in trying to provide fairly swift justice the FSA failed to do its homework. It relied too heavily on a small sample of transactions, reviewed by PricewaterhouseCoopers, an accounting firm, and hardened suggestions of potential mis-selling into proven breaches. The tribunal roasted the regulators for these errors.

Structurally, the system is seen to lack fairness. The FSA's enforcement arm makes recommendations to its Regulatory Decisions Committee (RDC), which is staffed by outsiders but chaired by an FSA employee. The RDC in turn sets any penalties. L&G is only one defendant to protest that it cannot get a fair hearing. Sir Philip Watts, former chairman of Royal Dutch/Shell, is another. His appeal to the tribunal is pending.

The good news is that the FSA is likely to learn from all this. John Tiner, its chief executive, says that the decision provides a "positive stimulus" to look at where the FSA can improve its procedures, "to do what we probably should have done anyway". A change of faces will help. The RDC is to have a new chairman—Tim Herrington, now a partner in Clifford Chance, a law firm. Andrew Proctor, the FSA's head of enforcement, left two weeks ago.

This fresh look may include using more often the FSA's statutory power to require firms themselves to appoint outside experts, with a duty of care to both company and regulator, to trawl through their records and identify wrongdoing. The FSA claims that L&G was unhelpful in providing information; the tribunal says the regulator should have been more aggressive.

Back on the other side of the street, L&G too has some housekeeping to do. The tribunal found that its procedures were patchy and that it did not do enough to ensure that buyers were well advised. Interestingly, though L&G challenged the fine, like other insurers it has paid compensation to some customers. ■