The Actuarial Profession
making financial sense of the future

consultation response

H M Treasury

Reforming Financial Markets

September 2009

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Reforming Financial Markets consultation responses
Financial Regulation Strategy
HM Treasury
1 Horse Guards Road
London
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Via email to: banking.reform@hm-treasury.gov.uk

28 September 2009

Dear Sir or Madam

Actuarial Profession response to the HM Treasury Consultation on Reforming Financial Markets

The Actuarial Profession welcomes the opportunity to comment on HM Treasury's proposals for reforming financial markets.

Many actuaries have strong links with the financial markets through their work in insurance companies and pension schemes. However, many actuaries also work for investment managers and banks, investing assets and creating solutions for these same insurance companies and pension schemes. The Actuarial Profession therefore has a strong interest in the integrity of the financial sector, and a deep familiarity with the issues involved.

Like many organisations, the Actuarial Profession has initiated its own response to the financial crisis. The Global Financial Crisis Group was set up to co-ordinate research from different parts of the profession, to initiate new research on important issues and to disseminate the results within the profession and beyond. This has included work commissioned from Cass Business School on how to deal with systemic risk in global financial markets, the results of which influence our response here.

The Actuarial Profession has also been active in other consultations, such as those relating to the Walker Review of corporate governance of UK banks and other financial industry entities and the Turner Review into the regulatory response to the global banking crisis.

There are a number of broad points that we would like to make in response to this consultation document. It is important that financial regulation is overhauled for deposit-taking entities. Greater security is important for investors and customers. However, it is important to strike the

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right balance. Regulation that is too stringent will be costly, ultimately for customers and policyholders, and may drive firms away from the United Kingdom.

Financial regulation for insurers was substantially overhauled a few years ago and the industry has so far emerged from the credit crisis relatively unscathed. Further important changes will take place in 2012 when Solvency II comes into force. Whilst some of the changes in governance proposed by Sir David Walker for systemically important insurers could usefully be adopted, we see little reason for further changes to prudential regulation for UK insurers at this time.

It is the issue of regulation and financial stability where we, as an organisation, feel that we can best add value in this consultation. We therefore answer questions only in these broad areas.

We hope that the response below is helpful, and would be happy to discuss it in more detail.

Yours faithfully

Paul Sweeting
Chairman of the Actuarial Profession Global Financial Crisis Group

Primary Legislation Proposals

1. What are the benefits in creating a more formal and transparent body to coordinate the authorities' more systemic approach to financial regulation? Do you have any views on the role and remit of the CFS?

The CFS appears to be a sensible formalisation of the existing standing committee. However, it appears that the main role of the CFS would be in crises. Furthermore, the proposals say nothing about the roles of the component institutions. The role and remit of the CFS appears to be based around co-ordination. This means that there is a risk that it will be simply a layer of bureaucracy. It would be preferable to have a single organisation responsible for regulation – even in times of crisis – with more formalised input from organisations such as HM Treasury and the Bank of England. It is also important to understand how the CFS would interact with the European Systemic Risk Council proposed in the Larosiere Report.

2. To what extent would an annual report on key developments increase knowledge and awareness of significant regulatory actions taken under the Banking Act and FSMA? From your point of view, what areas would it be useful for this report to cover?

This report would be helpful. Ideally it would include as much information as possible on any interventions required.

3. In addition to the input of non-executives from the governing bodies of the FSA and the Bank, what other ways could external advice and commentary be incorporated in this process?

It would be helpful to have a committee made up of representatives from stakeholders in the UK financial sector (including professional bodies, industry associations and consumer organisations) providing advice on a regular basis. This advice should be given to the CFS rather than the FSA or the Bank of England, so that its focus remains on systemic financial risk.

5. What are the benefits of giving the FSA an explicit objective for financial stability?

The main advantage here is that the FSA would be able to regulate firms not just in isolation but in terms of how they fit into the broader financial system. This should be a fundamental role of the FSA.

6. What are the advantages and disadvantages of amending FSMA to make clear that the FSA must take into account any possible wider economic and fiscal costs in its decision-making?

This would allow the FSA to consider financial stability as part of its regulatory remit. However, if this step were taken, then it would be crucial that the FSA had the resources it needed to carry out the significant additional level of analysis, or was directed to focus a greater proportion of its existing resources on systemic financial risk. It is also important to recognise that it would be challenging to determine how these factors were taken into account in practice.

7. What are the advantages and disadvantages of amending FSMA to place a duty on the FSA to promote sound international regulation and supervision?

International liaison between regulators will only increase in importance. It is therefore important to codify the FSA's position in this regard to remove ambiguity around which agency has responsibility for these international relationships. It could also – potentially – reduce the financial burden on the UK taxpayer and/or improve security for UK investors in cases where overseas financial institutions become insolvent. As with 6, any extension of the FSA's remit should be accompanied by an increase in funding or a change in focus.

8. To what extent would these proposals improve the FSA's ability to have a more systemic or macro-prudential approach to prudential regulation?

This would depend on the tools and, in particular, resources that the FSA were given with which to carry out an extended role.

9. Do you agree that the FSA's rule-making power and powers of intervention should be explicitly deployable in pursuit of any of its regulatory objectives and not just that of consumer protection?

Yes.

10. To what extent will the FSA's enforcement capability be enhanced by a power to suspend individuals or firms for misconduct?

This should be one of the FSA's tools, but only in conjunction with a clear and transparent process giving individuals and firms adequate opportunities to respond to allegations, and only with a clear definition of what constitutes misconduct.

11. To what extent will the FSA's enforcement capability be enhanced by a power to penalise persons who perform a controlled function without the necessary FSA approval?

To a great extent. The controlled function regime is potentially an important way of ensuring that only those able to hold important roles can actually do so.

12. Are the Government's proposed amendments to FSMA the best way of ensuring that the FSA can continue to take effective action to tackle abusive short-selling practices?

Yes. Transparency is the most appropriate control here, rather than anything more interventional.

13. Can you identify areas where the FSA does not currently have sufficient power to request information that it requires in order to carry-out more system-wide analysis of the financial sector?

Managers at the FSA are probably best placed to answer this question, but in broad terms the FSA should have access to detailed information on firms' sources of funding, investments and business plans. In relation to funding, information on the degree of leverage in the financial system would be of significant help to regulators in determining the level of systemic risk.

14. What are your views on this proposal to expand the role of the FSCS?

These proposals sound sensible, although it is important to consider the cost of the additional work and whether the UK or the other countries involved would pay for the additional workload.

Areas for Discussion

1. Do you agree that the systemic significance of a financial institution should be explicitly linked to regulatory capital requirements?

This is sensible for two reasons. First, the additional capital would reduce the risk of insolvency for systemically important firms; however, it would also discourage firms from growing to such a size that they were systemically important. It should be recognised, though, that depending on the level of additional capital required, a consequence of this could be demergers in order to avoid resulting dis-economies of scale. This could result in poorer value for consumers. Depending on the extent to which there is international co-ordination on such an approach, it could also leave firms at greater risk of takeover by overseas competitors, thus reintroducing systemic risk.

However, there is a danger in using capital as a principal tool of regulation. Not only is capital expensive, but as the Basel Committee on Banking Supervision note, it is not a substitute for good risk management.

2. How should systemically significant institutions be categorised? For example, should there be a fixed list or a sliding scale of importance, how often should such a list be updated, and should any list of systemic significance be made public?

There are a number of factors that ought to be taken into account, including market share in various types of business, volume of deposits and/or policies held, volume of outstanding derivative contracts, and so on. The speed with which these metrics can change means that a fixed list would be inappropriate. It would be preferable to have a numerical approach based on the various measures of importance. Any list should be updated annually or following any significant corporate actions. It should also be made public, but it should be recognised that any sudden changes in capital requirements for a particular firm could have an impact on the firm's share price. This suggests that large changes in capital requirements should be avoided with a graduated scale being used.

3. Can you identify any other important challenges to implementing stricter regulation on systemically significant institutions?

The main challenge is that the more systemically important an organisation is, the less transparent the organisation is likely to be.

4. Do you agree that banks should be required to establish more detailed contingency plans in times of failure?

We assume that, as in the consultation document, this question refers to contingency plans *for action* in times of failure. We agree that more detail is needed in these plans, and suggest that they be kept under continual review.

5. What steps could the Government take to increase competitive pressures in the market, to the benefit of consumers?

Increasing capital requirements for systemically important firms could increase competition between existing firms, though not necessarily to the benefit of consumers if economies of scale are lost. Our view is that in general the best way of increasing competition is through increasing transparency. It is also important to recognise that regulation acts as a barrier to entry in the financial services industry, thus limiting competition. This suggests that better, rather than more, regulation is needed.