

Principles v. Rules in Financial Regulation: Re-assessing the Balance in the Credit Crisis Symposium at Cambridge University, 10-11 April 2008

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The *European Business Organization Law Review* presents three articles, by Schwarcz, Kane and Mayes, analysing some of the main issues regarding principles versus rules in financial regulation. These articles result from papers presented at a symposium in April 2008 entitled 'Principles v. Rules in Financial Regulation' organised by the Centre for Financial Analysis and Policy and the Centre for Corporate and Commercial Law Studies at the University of Cambridge. The symposium attracted academics, policy-makers, regulators and practitioners from several leading jurisdictions representing a range of disciplines including accounting, economics, finance and law, who were invited to present papers on specific areas of the principles-versus-rules debate in financial regulation and to discuss the impact of the global credit and financial crisis on principles-based regulation.

The highly touted principles-based regulation (PBR) approach of the UK Financial Services Authority (FSA) came under scrutiny at the symposium and concerns were raised that the FSA's PBR approach had contributed significantly to regulatory failure with respect to several major UK banks and financial firms and to a general collapse of UK securitisation and inter-bank markets beginning in August 2007 and continuing until early 2009. Before the crisis, the FSA's principles-based regulatory approach was universally esteemed and held up as a model for many countries to emulate. The crisis has exposed, however, major weaknesses and flaws in the FSA's regulatory and supervisory practices and in particular how the FSA's PBR approach was conceived and applied in today's liberalised financial markets and whether it was responsible for the regulatory failures that arguably contributed to the massive financial market failures which toppled the UK financial system in 2007 and 2008 and which also contributed to the most severe global economic recession since the 1930s.

The origins of the FSA's PBR framework can be found in the self-regulatory regime that was adopted under the Financial Services Act 1986 leading to the creation of nine Self-Regulatory Organisations (SROs) which adopted high-level principles and rules to govern the practices of their members.¹ Principles-based

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¹ The UK government recognised that the previous regulatory framework set up as part of the 'Big Bang' institutional reforms was ineffective and proved costly and lacked transparency.

regulation had been an important component of UK banking supervision prior to the creation of the FSA. For instance, the Bank of England's supervisory approach to regulating the banking sector placed a strong emphasis on the set of values (principles) that the Bank deemed appropriate, and on close contact between Bank officials and the regulated banks. In other financial services, a self-regulator or a professional body was rather like a club. Members had to obey the club's general 'ethos' embodied in its principles as well as in specific rules. The concept of 'fit and proper' person derives from the era of the Self-Regulatory Organisations under the Financial Services Act 1986.

After the FSA was established in 2000² in response to a number of major regulatory failings by SROs and the Bank of England, it sought to avoid the reputation as an onerous super-regulator with broad powers to adopt prescriptive rules and to impose sanctions that might limit financial innovation and drive up the costs of doing business in UK financial markets. It was therefore necessary for the FSA to create a market-friendly image that would prevent London from losing its leading position as an international financial centre.³ As a result, the principles-based regulatory approach of the Bank of England and the SROs was embraced by the FSA. It became an FSA regulatory objective to 'continue developing principles-based regulation in the UK.'⁴

FSA prudential regulation became principles-based and 'light touch'. The regulatory focus would be on compliance processes, rather than on the strict application of prescriptive rules. The overall goal of FSA principles-based regulation was for the regulator to create incentives for firms to design compliance processes and governance strategies that would achieve overall firm objectives (i.e., shareholder wealth maximisation) while also achieving the FSA's regulatory objectives.⁵

See HM Treasury, *Financial Services and Markets Bill: A Consultation Document. Part One: Overview of Financial Regulatory Reform*, 1998a.

² The FSA was charged with the responsibility to regulate a very broad range of activities and markets. The Financial Services and Markets Act 2000, Chapter 8, section 1(2), enumerates the FSA's statutory objectives as promoting 'market confidence', 'public awareness' and 'protection of consumers', and 'reduction of financial crime'. C. Briault, *The Rationale for a Single Financial Regulator*, Financial Services Authority Occasional Paper No. 2, 1999, available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=428086>.

³ Indeed, then UK Chancellor of the Exchequer, Gordon Brown, stated on 25 September 2006: 'What we have succeeded in doing is having regulation that not only has a *light touch* but also that is *limited regulation*.'

⁴ Speech by the Economic Secretary to the Treasury, Ed Balls MP, at the FSA Principles-Based Regulation Conference, 23 April 2007, available at: <http://www.hm-treasury.gov.uk/speech_est_230407.htm>. For further reference, cf., Financial Services Authority, *Principles-based regulation: Focusing on the outcomes that matter* (April, 2007).

⁵ For example, firms were given freedom to design their own internal risk management systems as long as they achieved the FSA's 11 high-level principles.

The FSA has stated that principles-based regulation is necessary to regulate effectively in a continuously changing financial marketplace. Indeed, prior to the credit crisis, the FSA stated in a policy paper in March 2007 that

‘Past experience suggests to us that prescriptive standards have been unable to prevent misconduct. The ever-expanding rule books of our predecessor bodies and our consolidated Handbook, designed to prevent misdemeanour, have not stopped further mis-selling, market misconduct or other detriment. Instead we believe that detailed rules have become an increasing burden on our own and the industry’s resources.’ (FSA 2007)

The FSA’s principles-based approach emphasised that financial markets are constantly changing. Continuous innovation and new product development are important ways in which the financial services industry generates benefits for consumers and markets. It was important therefore that regulation could respond rapidly to the pace of change in markets and so allow regulatory principles and practices to continue to develop for the benefit of their users.

Crucially, the FSA rejected (or at least de-emphasised) prescriptive rules and instead focused on outcomes as more likely to support financial development and innovation. It was firmly held that any set of prescriptive rules was unable to address changing market circumstances and practices at all times, and would inevitably, in certain circumstances, inhibit market innovation. The FSA observed that ‘[i]n a quickly changing marketplace, principles are far more durable.’ (FSA 2007)

The FSA has recently committed itself to a re-assertion of the principles-based approach to regulation. There will need to be ‘greater contact between FSA and senior management of the firm reflecting the increased focus on the responsibilities of senior management, away from FSA: specialist compliance function contact.’⁶ The 2009 Turner Report also reaffirms the importance of the principles-based framework for UK financial regulation. Indeed, the FSA’s business plan for 2008/2009 reaffirms the FSA’s commitment to PBR under changing and challenging market conditions. The report, though recognising the challenges that the crisis has posed for PBR in ‘a difficult year’, provides that the UK’s regulatory difficulties and the crisis have not ‘in any way undermine[d] our general approach to regulation.’ The report further states ‘that a full analysis will support [the FSA’s] move towards a more principles-based approach to regulation with its emphasis on both the FSA and firms’ management focusing on the consequences of firms’ actions rather than on rigid adherence to specific rules.’⁷ The FSA’s PBR approach therefore does not appear to have changed or to have been considered one of the areas where the FSA needed to improve its prudential

⁶ Callum McCarthy, then Chairman, FSA (2007).

⁷ Financial Services Authority, Business Plan 2008/2009, p. 7.

regulatory practices in light of the crisis. As discussed below, UK policy-makers and the FSA have crucially failed in learning some of the main lessons of the credit crisis: that regulation cannot be mainly focused on an outcomes-based approach at the firm level without also taking into account how individual firm practices (i.e., the pricing of risk and regulatory compliance) may be affecting the aggregate level of risk and stability in the financial system.

The articles in this series address these regulatory risks in the context of the principles-versus-rules debate in a number of different contexts. In the first article, Professor Steven Schwarcz of Duke University analyses the normative implications of full adherence to a principles-based regime when the enforcement regime results in full liability for the trustee of securitised bondholders if the trustee decides not to enforce fully the private law contractual claims of the bondholders against the issuers of defaulted mortgage-backed securities. In the second article, Professor Edward Kane of Boston College argues that the crisis of 2007-2008 can be attributed to a major misalignment of the incentives of regulators and supervisors, managers and investors. In the third article, Professor David Mayes of the University of Auckland and the Bank of Finland examines the balance between principles and rules in the context of European banking regulation and argues that EU Member State regulators have yet to strike a balance between the use of a common rule-book and common principles for the prudential oversight of EU banks with cross-border operations.

Finally, it should be noted that a primary risk on which 'principles-based' and 'risk-based' regulation is focused is the risk to orderly markets – systemic risk. The classic example of a systemic risk is a bank run. A depositor at a particular bank would be willing to leave funds on deposit, but believes that other depositors are likely to withdraw their funds, forcing the bank to call in loans or sell securities and suffer losses, perhaps even suspending payments. In the financial markets of today, however, the role of the regulator has become as much involved with risks inherent in market structures and counter-party relationships, as in the prudential activities of individual firms. Indeed, the newly-elected Labour Government of 1997 recognised this in its election manifesto by proposing the creation of the FSA, which would exercise prudential regulatory authority over individual financial institutions and firms, while also regulating capital markets and financial market structures, such as clearing and settlement. The FSA's PBR regime, however, focused on the risk-taking of individual firms while not taking into account the aggregate effects of firm risk-taking on the financial system. So long as firm risk management models appeared to price risk efficiently on an individual firm basis during normal times, there was no need (so thought the FSA) to be concerned about off-balance-sheet structures that were allowing risk and leverage to build up in the broader financial system outside of the legal control of individual financial firms. The PBR outcomes-based approach allowed firms to demonstrate that they were achieving satisfactory outcomes: increased share prices and growing profitability based on high levels of leverage. The PBR

approach failed to take account of the potential risks to the stability of the financial system which might become especially virulent during an extraordinary and unexpected event that could result in a sudden loss of confidence by investors in what were considered to be safe and liquid investments.

Rather, the PBR approach focused on individual firm results, which look satisfactory during normal times, but which do not take into account growing risks at the level of the financial system. To address these risks for the future, PBR will need to become more rules-based at the level of the financial system. The Turner Report states that ‘macro-prudential’ regulation will become the new regulatory model to control systemic risks in the financial system. Macro-prudential regulation can be divided into two main areas: (1) the regulation of individual firms must take into account both firm level practices and broader macro-economic developments in determining how regulatory requirements will be imposed (i.e., growth of asset prices and contra-cyclical bank provisioning), and (2) controls on the levels of risk-taking and leverage at the level of the financial system. If adopted, macro-prudential regulation will prove to be a challenge for principles-based regulation because it will require that rules be adopted at the level of the financial system to control leverage and other risks. This will indirectly lead to rules-based controls on individual firm risk-taking in order to comply with broader macro-level controls and regulations. PBR will necessarily become more rules-based and less outcome-focused. Another lesson for the UK is that the new focus on macro-prudential controls at the level of the financial system will require the FSA to play a greater role in monitoring systemic risk and imposing controls at the level of the financial system. In other words, the FSA will become the key player in the regulation of systemic risk, not the UK central bank, the Bank of England. The FSA would exercise primary regulatory authority to address the market failures that arise from interconnected financial markets and the shifting of risk off-balance sheet to ‘shadow’ sectors of financial markets. Although not recognised fully yet by the FSA, the new PBR approach based on macro and micro rules-based controls will change the nature of financial regulation dramatically and possibly lead to new regulatory risks that will arise because of the responses of market participants who will undoubtedly seek to avoid these regulatory controls by adopting innovative financial instruments and structures. This will be the main challenge for PBR in the future – across all jurisdictions.