HOUSE OF COMMONS SESSION 1994-95

TREASURY AND CIVIL SERVICE COMMITTEE

Sixth Report

THE REGULATION OF FINANCIAL SERVICES IN THE U.K.

VOLUME III

Appendices to the Minutes of Evidence

Ordered by The House of Commons *to be printed*
23 October 1995

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The Treasury and Civil Service Committee is appointed under Standing Order No 130 to examine the expenditure, administration and policy of the Treasury and the Office of Public Service and Science (but excluding the Office of Science and Technology and the drafting of bills by the Parliamentary Counsel Office), the Board of Customs and Excise and the Board of the Inland Revenue.

The Committee consists of a maximum of 11 members, of whom the quorum is three. Unless the House otherwise orders, all members nominated to the Committee continue to be members of it for the remainder of the Parliament.

The Committee has power:

(a) to send for persons, papers and records, to sit notwithstanding any adjournment of the House, to adjourn from place to place, and to report from time to time;

(b) to appoint specialist advisers either to supply information which is not readily available or to elucidate matters of complexity within the Committee's order of reference;

(c) to communicate to any other committee appointed under the same Standing Order (or to the Committee of Public Accounts or the Deregulation Committee) its evidence and any other documents relating to matters of common interest;

(d) to meet concurrently with any other such committee for the purposes of deliberating, taking evidence, or considering draft reports.

The Committee has power to appoint one sub-committee and to report from time to time the minutes of evidence taken before it. The sub-committee has power to send for persons, papers and records, to sit notwithstanding any adjournment of the House, and to adjourn from place to place. It has a quorum of three.

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13 July 1992

The following were nominated as members of the Treasury and Civil Service Committee:

Ms Diane Abbott	Mr John Garrett
Sir Thomas Arnold	Mr Barry Legg
Mr A J Beith	Mr Giles Radice
Mr Nicholas Budgen	Mr Brian Sedgemore
Mrs Judith Chaplin (decd 19.2.93)	Mr John Watts
Mr Quentin Davies	

Mr John Watts was elected Chairman on 15 July 1992.

Sir Thomas Arnold was elected Chairman in the place of Mr John Watts on 19 October 1994.

The following changes in the membership of the Committee have been made.

Monday 29 March 1993:	Mr Nigel Forman appointed.
Monday 13 December 1993:	Mr John Garrett discharged. Mr Mike O'Brien appointed.
Monday 31 October 1994:	Mr John Watts discharged. Mr Matthew Carrington appointed.
Wednesday 28 November 1994:	Mr A J Beith discharged. Mr Malcolm Bruce appointed.

The cost of preparing for publication the Shorthand Minutes of Evidence published with this Report was £4,346.

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5. Letter and enclosure from Mr Richard Alexander MP.
6. Letter from Mr Toby Micklethwait.
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8. Letter from Mr A B Craven, Home Income Plan Support Group.
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APPENDICES TO THE MINUTES OF EVIDENCE

APPENDIX 1

Letter from the Chief Executive of the Personal Investment Authority (PIA)

PIA RESPONSE TO THE COMMITTEE'S INTERIM REPORT

My Chairman, Joe Palmer, and I met Mr Watts on 13 July for a discussion on the PIA's response to the recommendations contained in the Committee's Interim Report on Retail Financial Services Regulation. I am writing to report on the outcome of that discussion.

PIA had already publicly welcomed the general thrust of the Report, in particular the conclusion that any future change in regulatory practice should build on the progress that has recently been made; and the Committee's statement that it is persuaded by the arguments in favour of the creation of a single broadly-based regulator for the retail sector of the financial services industry. Since then, the SIB announced its decision to recognise PIA as an SRO with effect from 18 July. PIA believes that this has materially improved the climate of opinion, particularly within the industry, by removing uncertainty about the PIA's future to which the Committee's Report also draws attention.

In our discussion with Mr Watts we agreed that the Committee's recommendations fall into two broad groupings, namely governance and the regulatory agenda. I will deal with each of these separately.

On *governance:* the gist of our discussion with Mr Watts was that most of the issues raised under this heading are essentially of a longer term nature. Our Board reviewed these in depth at the first meeting following the publication of the Report and it is our intention to revert to them in the Autumn. In the meantime I believe it is worth recording the following points:

(i) the Board considered Mr Palmer's own position in the light of paragraph 71 of the Committee's Report and gave Mr Palmer a unanimous vote of confidence. Mr Palmer has asked me to convey to the Committee through you that he believes he has contributed and can continue to contribute to the establishment of PIA as an effective regulator, but he wishes to assure the Committee that he understands their concerns and does not take them lightly;

(ii) the Board agrees with the Committee's observations on the size of the Board and on each occasion when a retirement by rotation arises will actively consider the scope for a reduction in size;

(iii) the Board has resolved that in future the nomination of public interest directors will be subject to the consent of the SIB and we will make certain through appropriate external consultation that the pool of names from which such nominations are drawn will be as broadly-based as possible;

(iv) the Board recently appointed Miss Helena Wiesner, a well known and highly respected consumerist, as Deputy Chairman in succession to Peter Taylor.

Turning now to the various items on the *regulatory* agenda; most, if not all, of these are in hand or subject to active investigation. We suggested that the Committee might find it helpful to have a progress report on all these points together with any other relevant matters such as the admissions process in the Autumn and Mr Watts agreed that this would indeed be a helpful way forward.

1 August 1994

APPENDIX 2

Further letter from the Chief Executive of the Personal Investment Authority (PIA)

PIA's FURTHER RESPONSE TO THE COMMITTEE'S INTERIM REPORT

You will recall that in my letter dated 1 August 1994, in which I set out PIA's response to the recommendations contained in the Committee's Interim Report on financial services regulation, I suggested that the Committee's recommendations fell into two broad groups, namely governance and the regulatory agenda. In my letter I suggested that your Committee might find it helpful to have a progress report on these points, together with other relevant matters such as the admissions process, in the Autumn. The purpose of this letter is to provide that report.

Admissions Process. The Securities and Investments Board set a deadline of 30 September 1994 by which time potential members of PIA were required to either apply to PIA or another suitable regulator for membership. By midnight on that date, 4.926 firms had applied. At the time of writing 2,702 firms have been admitted and it is estimated that the Membership Committee will have completed its work scrutinising the applicants transferring from other regulatory bodies by early spring.

Rule Book. PIA's new Rule Book became effective on 18 July 1994 following a consultation with a wide range of prospective members on the draft Rule Book published with the Prospectus on 15 February 1994. The substance of the material which appeared in the original draft has not, however, been significantly changed although the new material which has been added includes: transitional provisions, requirements for stationery and status disclosure, a statement of rules specifying the basis for fees and for compensation fund levies.

Members and prospective members have also been provided with a reprinted copy of the adopted rules of FIMBRA, IMRO, LAUTRO or SIB with the necessary modifications (on, for example, deletions where rules have been replaced by PIA's new rules or where PIA's scope is narrower).

A Rules Committee has been established under the Chairmanship of Sir Kenneth Clucas whose task it is to keep under review the rules themselves and to recommend rule changes to the Board as necessary. Members of this Committee are listed at Annex A.

Training and Competence. PIA considers that one of its most important initiatives in delivering higher standards of investor protection is the introduction of its Training and Competence scheme. This has been developed through detailed discussions with professional and trade bodies. A consultative document will be issued this month and consultations with our members and prospective members will continue until January 1995. A summary of the Consultative document is at Annex B. It is anticipated that detailed rules and guidance will be issued in the late spring in time for the scheme to be launched in July 1995.

Registration. PIA will maintain a register containing details of the advisers, sales staff and also of principals of appointed representative firms working for each member firm. This will allow PIA to track individuals working in the industry. Work continues on possible additional steps including, in particular, individual contracts between PIA and advisers, sales staff and other key staff working for member firms. Such a development would enable PIA to take disciplinary action directly against relevant individuals in addition to, or instead of, against the member. PIA will consult widely before reaching decisions on the best way forward.

Employment Practices. A number of PIA members and prospective members are currently introducing changes to their remuneration arrangements. In a number of cases, these changes have been influenced by the requirement on firms to disclose commission, and commission equivalent, with effect from 1 January 1995. PIA will continue to monitor the position. The nature of a firm's arrangements for remunerating its staff is one of the factors which PIA takes into account in determining the frequency with which it will visit that firm. We will be introducing an improved regular monitoring system which will be made possible by an increase in our total number of field staff.

Membership Fees. The structure for fees was published in July to cover the first period of operation up to the end of the financial year March 1995. As indicated in our prospectus, fee structure would mirror that of the four existing regulators and it is the Board's intention that this should not be changed for the first two business years up to April 1996. It is the Board's intention to invoice all members annually in advance on the 1st April each year and, in the first year of business, fees will become effective from the date of joining. The Board also agreed that, given the difficulties of establishing PIA's finances in the first year of trading, payment of fees by instalments should be considered in the context of an overall review of PIA's basis for charging fees on which the membership would be consulted during the coming financial year.

OTHER AREAS OF PROGRESS

Status Disclosure. A consultative paper was issued in July and new rules on status disclosure have been made. The proposed regime is intended to clarify the polarisation status of a member and its appointed representatives and to explain to the investor in very clear terms that the Company is regulated by the Personal Investment Authority. Firms will be required to implement fully the new status disclosure requirements by no later than April 1995.

Complaints Procedure. PIA's complaints procedures came into effect on E Day, 18 July, and arrangements are in place with both FIMBRA and LAUTRO to cover the transitional period. An Ombudsman, Mr Stephen Edell, has been appointed and the Ombudsman Bureau has been established since July.

Financial Resource Requirements. Following representation from many potential members over the issue of capital adequacy the Board decided to introduce transitional arrangements for certain of the financial resource requirements. This allows certain classes of member firms more time to meet the increased requirements specified in the Rules.

Non Life Disclosure. Consultation on the introduction of a disclosure regime, similar to that being introduced for the Life Insurance products, is in progress for "non life" packaged products such as Unit Trusts. The introduction of such a regime, which will come into effect early in 1995 will provide investors with not only information concerning commission and remuneration but also a standard system of disclosure of Key Features for packaged investment products.

22 November 1994

ANNEX A

MEMBERSHIP OF THE PIA RULES COMMITTEE

Sir Kenneth Clucas	Chairman	FIMBRA
George Baker	Compliance Officer	Lloyds Bank plc
Jeremy Birchill	Group Legal Officer	M&G Group
Ken Davy	Chairman	DBS Financial Management Ltd
Paul Etheridge *	Chairman	Prestwood Etheridge & Russell Ltd (Independent Financial Advisers)
Richard Godfrey-Fawcett	Managing Director	C E Heath Ltd (Financial Services)
Brian Hewitt	Compliance Officer	National Deposit Friendly Society
Jeremy Mitchell	Consumer Affairs Specialist	Public Interest Director PIA
Philip Monks	Manager Legal Services	Sun Alliance Life & Pensions
W J Robertson	Head of Product Marketing	Scottish Amicable Life Assurance Society Ltd
Jeremy Willoughby	Company Secretary	Gartmore plc (Director PIA)
Charles Wilson	Company Secretary	Nationwide Anglia Building Society
Clive Wood	Head of Compliance	Midland Personal Financial Services
* Michael Rose	Substitute for Paul Etheridge	Rose & Associates (Independent Financial Adviser)

ANNEX B

SUMMARY OF PROPOSALS

TRAINING AND COMPETENCE

The Board agreed an exposure draft of the Consultative Paper at its April Meeting, it has been discussed with 25 organisations and with the Small Business and Consumer Panels. The present draft of the Consultative paper takes account of those discussions.

The key elements of the proposals include:

- — full FPC/IAC for new entrants except for those advising on a very limited range and level of products for whom Paper 1 of FPC/IAC is sufficient.
- — no "grandfathering" of experienced advisers; they will have to demonstrate their competence but will be offered three alternative routes by which to do so. These are: full FPC/IAC, FPCI plus viva voce examination, FPC/IAC plus approval of a portfolio at work. Those who cannot achieve the requirements within two years will be required to operate under "direct-supervision"

and given a further two years to comply with the requirements before having to terminate their advisory activities.

— those involved in the supervision will be required to achieve the full FPC/IAC and undertake specialist supervision training.

— those individuals involved in the provision of indirect but case-specific advice will be required to undertake appropriate training including FPC/IAC.

— all advisers will be required to undertake an appropriate programme of Continuing Professional Development.

— all advisers will be required to maintain a record of their training and development activity.

The timetable for implementing the proposals is:

Consultation: Nov 90–Jan 95

Report to Board: Mar 95

Rules and Guidance issued to members: Apr 95

Training and Competence requirements as set out in the proposals are likely to lead to additional costs and members will be asked to consider this aspect in their response to the proposals.

Note:

FPC: Financial Planning Certificate offered by Chartered Insurance Institute

IAC: Investment Advice Certificate offered by Securities Institute

Each certificate offers 3 levels of qualification. Level 1 confirms generic knowledge, levels 2 and 3 confirm more advanced knowledge.

APPENDIX 3

Letter from the Chairman of Nomura International

Thank you for your letter of 15 May inviting me to contribute to your inquiry into the regulation and supervision of derivative trading.

My senior colleagues and I have given your invitation full consideration and, on the whole, we prefer not to make a submission.

For this reason I am afraid we must decline your invitation. However, we hope that the inquiry is successful in achieving its objectives and we look forward to seeing the results in due course.

23 May 1995

APPENDIX 4

Letter and Memoranda from the Bank of England

When the Governor, Messrs Quinn and Smout gave evidence to the TCSC on 5 April[1], Mr Quinn undertook to provide papers to the Committee about the link between Derivatives and Speculation and on Consolidated Supervision. I enclose papers on these subjects.

The Committee also asked about the timing of the agreement of bonus payments at Barings. I understand that the allocation of bonuses was finally agreed in the week beginning 20 February and the vast majority of staff had been informed of their intended bonus award by 24 February. The timing of these announcements was at the equivalent time in 1994. ING took the view that it was contractually obliged to pay the bonuses, and in any event, wished to do so to retain the staff, who are significant assets of the businesses it acquired.

24 May 1995

[1] See HC (1994–95) 332–iii.

DERIVATIVES AND SPECULATION

Speculation

1. Taken in its widest sense, the terms speculation and gambling can be stretched to include all risk taking. For instance, bank lending could be described as speculative, since it exposes banks' shareholders and depositors to both credit and interest rate risk in the hope of earning profits from so doing. Furthermore, UK banks have historically been exposed to considerable foreign exchange risk, as they have been willing to lend in currencies other than sterling in order to finance trade and foreign investment. More recently, the range of significant risks has widened still further as banks have engaged in both equities and commodities trading.

2. This note looks at banks' use of derivatives in this context. It considers the degree to which banks might use derivatives so as to take (rather than reduce) risk (ie to speculate rather than hedge), and the ease with which the income from such position taking can be separately identified.

Credit risk

3. Almost all banking activities involve credit risks—to the recipient of a loan, the issuer of a security or the counterparty to a transaction. Banks manage such risk mainly by determining in advance the type of counterparty that they are willing to deal with—retail or wholesale; small or large corporate; investment grade or not. Once assets are on the balance sheet, there are relatively few means of reducing credit exposure. One is to sell the asset where this is marketable[2], another is to take collateral or guarantees; and a third is to use bilateral netting[3]. Although reference is occasionally made to 'credit-derivatives', banks do not use these at present to reduce credit risk to any significant extent. Indeed, in attempting to hedge market risks through other derivative products credit risk may sometimes be increased.

Market risk

4 In comparison with credit risk, it is more straightforward to hedge market risks, by buying an instrument with an equal but opposite exposure to an underlying price (eg a particular exchange rate). In other words, the decision to take on market risk can be separated from the decision to invest in a particular asset.

5. In practice reality is rather more complex. All banks set limits so as to specify the risk that they are prepared to take in this area. Such limits are an important part of the control environment in a bank. As a result a bank can respond to a request from one of its customers to carry out a transaction and then choose—in the light of their trading strategy—whether to hedge or to leave some part of the position open for the time being. Normally cash and derivative instruments are managed together as part of a portfolio, in which some instruments are acquired as a result of quoting prices to customers and others are bought specifically to hedge (or take) market risks.[4]

6. That said, in many cases the hedge which is used is imperfect. For instance a bank may protect itself against *overall* movements in interest rates but be exposed to loss, for instance, if six month rates move more than nine month rates. This may either be done as part of a deliberate bet on the differential, or as an approximation to a hedge. The appropriate degree of precision in this area will depend on the nature and scale of a firm's business. In many cases the *precise* distinction between a hedge and speculation will be difficult to draw. This does not mean that banks should not try to identify the sources of their profits in more detail, particularly where trading forms an important part of their activities. But it does suggest that at the margins the boundary between profits from speculation and profits from customer business and/or hedging can be very difficult to determine.

Identifying income sources

7. It has been suggested that banks should publish details of profits, showing the extent to which these are generated by speculative activity. Even if the term speculation, is taken as relating just to market risk in trading activities, this is far from straightforward to achieve, for the reasons set out above. It should also be noted that derivative instruments will be used both to hedge and to take positions, rather than exclusively for one or the other purpose.

8. The simplest (but potentially most costly) means of identifying income from speculation would require banks to split their trading portfolios into two—a hedged and an unhedged portfolio. This, however, would require difficult judgements as to how precise a hedge would need to be to qualify as such,

[2] It is increasingly the case that loans can be packaged to form marketable securities.

[3] Subject to stringent legal safeguards, supervisors allow banks to offset amounts owed by a counterparty against amounts owed to the same counterparty.

[4] Most customer business will lead to intra-day exposures even for a bank which "does not take positions", although in many cases these will persist for only a matter of minutes. All of these carry with them an element of risk; this is the corollary of providing customers with services promptly on a principal-to-principal basis. More generally, speculators who take risks can provide liquidity to the market, and hence allow customer orders to be completed more cheaply than would otherwise be the case.

and how long firms would be given to hedge their customer business. The same issues would arise if a single portfolio were run in which each instrument were labelled as it was acquired according to the purpose for which it was intended. Given the speed with which positions move as a result of customer business, unless there was a certain amount of flexibility in this area, the compliance costs for banks (and ultimately their customers) would be very significant.

ARRANGEMENTS FOR CONSOLIDATED SUPERVISION OF OVERSEAS SUBSIDIARIES

1. In this note the term "consolidated supervision" means a qualitative assessment of the overall strength of a group to which a bank belongs, in order to evaluate the potential impact of other group companies on that bank. Consolidated supervision does not imply that the Bank is responsible for the supervision of all the companies in a group to which an authorised bank belongs; it refers to the supervision of that bank as part of its group.

2. The Bank's approach to the consolidated supervision of overseas subsidiaries is in line with the EU Directive on the Supervision of Credit Institutions on a Consolidated Basis, issued in 1992, and with the Revised Basle Concordat of 1983, which sets out the division of responsibility between the parent (home) and overseas (host) supervisors of foreign banks. The principles are as follows:

3. Where a banking *subsidiary* is established overseas, the primary responsibility for its supervision lies with the host supervisor. (Reflecting this our 1987 Banking Act makes no distinction between foreign-owned banks incorporated in the UK and domestically-owned banks.) Unless otherwise agreed, the host supervisor's responsibilities will cover areas such as the analysis and oversight of systems and controls, the quality and appropriateness of local management, internal audit and compliance, and the adequacy of local capital and liquidity arrangements.

4. The Concordat also makes clear that home supervisors have a role to play in such cases. In particular they should take account of the activities of other parts of the group insofar as they might affect the reputation and financial soundness of the parent bank. This means that the subsidiary should be included in the group-wide assessment of capital adequacy and large exposures. It does not mean that the home supervisor should separately review the capital adequacy of individual entities within the group which it has not authorised, nor oversee such entities' systems and controls, quality and appropriateness of management, internal audit or compliance. These remain the responsibility of the relevant local supervisor. Similar principles govern the way in which the Bank carries out its consolidated supervision of securities subsidiaries of banks, either in the UK or overseas.

5. How does the Bank carry out this task? Risk analysis is undertaken both on a consolidated and unconsolidated basis, in the latter case to ensure that capital is distributed appropriately within the group. Most financial companies are consolidated using a technique called 'line by line" or "accounting" consolidation, in which case the scale of risk and adequacy of capital are assessed using the Bank's rules, regardless of the location of business. For these purposes it is generally assumed that "excess" capital is freely transferable round a group; partly for this reason it is not a substitute for supervision of individual companies in their own right.

6. In some cases different techniques for carrying out consolidation may be used:

— *where the relationship between parent and subsidiary is particularly close, the subsidiary may be solo-consolidated. In other words, the subsidiary is treated as if it were part of the parent for capital adequacy and large exposure purposes.*

For solo consolidation a subsidiary must be at least 75% owned by the parent bank, effectively managed by the parent and either be funded wholly by the parent or have risk exposure only to the parent. There must be no potential obstacles to the payment of surplus capital to the parent, and sufficient capital in the parent's balance sheet to support its investment.

— *where consolidation is inappropriate, the investment in subsidiaries is deducted.*

Line by line consolidation of certain subsidiaries would be misleading (eg industrial companies; insurance companies). In these cases the value of the subsidiaries is deducted from the consolidation.

— *where the subsidiary is a UK-incorporated securities firm, the subsidiary is subject to "deduction plus".*

On the basis that the financial rules applied by SROs are a more accurate measure of the risks faced by investment firms, such subsidiaries are included in consolidated returns using a technique called deduction plus, whereby the greater of the value of the bank's investment in the subsidiary and the SRO's capital requirement is deducted from consolidated capital. For large exposure purposes line-by-line consolidation continues to apply.

7. Even where one of these forms of consolidation is applied to a subsidiary, this does not mean that the same approach will be adopted in relation to that firms' own subsidiaries, which may be captured in the consolidation in other ways. Thus an overseas securities subsidiary of a bank will normally be subject to line-by-line consolidation for the purposes of capital adequacy and large exposures, even where its immediate parent is a UK-incorporated securities firm subject to deduction plus or solo consolidation.

8. Importantly, the Bank regards consolidated supervision as a complement to, rather than a substitute for, the solo supervision of the parent bank (and any subsidiaries solo-consolidated with it). This is because events elsewhere in the group can pose a threat to the authorised institution in ways which consolidated supervision cannot detect. Hence the Bank sets solo capital adequacy ratios and large exposure limits for UK-incorporated banks in addition to those applied at the consolidated level.

9. Where a bank establishes a *branch* overseas, the host supervisor does not have responsibility under the Concordat for capital adequacy, but has a role in the local monitoring of foreign exchange and liquidity positions and the oversight of systems and controls. At the same time the liquidity and foreign exchange positions of overseas branches are taken into account by the home supervisor in its supervision of the bank.

10. Within the EU, these principles have been given force of law through the Second Banking Law Co-ordination Directive. The role of the host supervisor in relation to such branches is restricted to the monitoring of liquidity and market risk positions (such as foreign exchange) in the branch. These arrangements are subject to bilateral Memoranda of Understanding between the home and host supervisor.

11. Although it has been adopted by banking supervisors more widely, the Concordat formally applies only to G-10 banking supervisors. Securities supervisors do not have an equivalent document. However, under the minimum standards agreed in 1992 in Basle all international banking groups and international banks must be subject to adequate consolidated supervision by the home supervisor. If this is not satisfied, the host supervisor is free to turn down any application for authorisation as a bank.

APPENDIX 5

Letter from the Governor of the Bank of England

Thank you for your letter which you sent me shortly before I gave evidence, with colleagues, to the Committee as part of your inquiry into derivatives. I had an opportunity to touch on some of these questions at that hearing but I thought that I should respond formally to your letter and I am sorry to have taken some time to do so.

While the major banks do provide some information about gross dealing profits in their annual reports, you are right to suggest that few, if any, separately identify net revenues from proprietary trading alone. I can therefore well understand the thought that more information and transparency would be advantageous. The practical problem is in producing information in a consistent and meaningful form so that it would be useful to the reader.

Banks themselves do not primarily monitor their proprietary position in derivatives alone because the risk will depend on the shape of the rest of their balance sheets; banks undertake proprietary trading not only in derivatives but in a wide variety of cash markets too. It could therefore be misleading to look only at positions in the derivatives market as some of these would be the counterpart of positions in cash markets. Similarly, proprietary trades might offset some of the market risks in plain vanilla banking—the extending of credit—through the hedging of positions. For example, fixed rate mortgages can be offered by banks, despite their being funded primarily by short-term variable rate deposits, because the position can be hedged in the futures markets. In other words, by meeting customer demand the bank acquires a position which it can then choose to hedge or not. In practice, it is quite hard to separate out what is a pure hedge and what is a separate position.

In fact many hedges are imperfect. For instance, some banks will choose to protect themselves against changes in the general level of interest rates by "hedging" a six month position with one at nine months. How well this works as a hedge will depend on whether these rates move together or not. Others will deliberately run a position of this sort expecting to make money from future rate movements. All this suggests it is genuinely difficult to accurately distinguish profits from proprietary trading, quite apart from the problems in allocating costs between this activity and customer business.

I would nevertheless be the first to agree that these important definitional issues should not obscure the basic issue which is how much risk individual banks are taking. Here bank management and their supervisors face the same problems in trying to assess what information is most relevant. It is probably the case that no single number can best summarise the position for each particular bank. On market risk, for example, many of the more sophisticated banks are now using value at risk measures to summarise the risks run in their banks. So far as credit risk is concerned, you will have seen from the statistics in the article from the Bank of England's Quarterly Bulletin which I left with the Committee after the hearing (and which was published last week), that the magnitudes involved, while still large, are very much less than the headline figures for OTC derivatives business. Some standardisation of such measures would no doubt be helpful. We are seeking to make our own contribution, in consultation with other supervisors internationally and domestically and with banking experts. Other bodies are working on the issues of measurement and disclosure—the UK Accounting Standards Board is reviewing the accounting treatment and the British Bankers Association is revising its 1991 Statement of Recommended Accounting Practice on off-balance sheet investments. Abroad, the US Financial Accounting Standards Board has also proposed revised accounting treatment and the International Accounting Standards Committee is proposing greater disclosure in a standard expected to be applied from next year. These initiatives are described in the Bulletin article to which I have referred. That article also discusses initiatives by other groups to promote greater disclosure, notably by the G30, the Institute of International Finance and the BIS on behalf of the Governors of the G10 central banks. The Bank has been most involved in this last initiative and I enclose a copy of the discussion paper by the Working Group set up by the G10 Governors. The report does recommend greater disclosure of market risk but in ways that reflect the trading activities of the reporting institutions and the way that the risk changes over time—not just the risk at the date of the accounts.

I am also sending a copy of the new guidelines just produced jointly by the Basle Committee on Banking Supervision and the Technical Committee of IOSCO (the equivalent group for supervisors of securities firms) on the information banks and securities firms should provide to their supervisors about their derivatives activities. I have attached to it a copy of the Brockmeijer report which is referred to in the guidelines. [Not printed]

As you will see there is no obvious or simple solution but we are pressing ahead as fast as we can. I hope that we will before too long be in a position where banks and other financial institutions will regularly publish meaningful information on all this.

22 May 1995

APPENDIX 6

Memorandum submitted by the Accounting Standards Board

1. Introduction

This paper has been prepared by staff of the Accounting Standards Board (ASB), which is the body responsible for setting accounting standards in the UK. The paper summarises work being carried out in both the UK and elsewhere to develop accounting standards for financial instruments (including derivatives). The remainder of the paper is structured as follows:

— Section 2 briefly describes the ASB's financial instruments project

— Section 3 summarises financial instruments projects being carried out by other major standard-setters elsewhere in the world

— Section 4 considers relevant accounting guidance produced for UK banks by the British Bankers Association and plans to update that guidance

— Annex I sets out the role of the ASB and the status of the standards that it produces

— Annex II describes in more detail the ASB's work to date in its financial instruments project.

2. The ASB's financial instruments project

The Board is giving priority to the project on financial instruments. The project began a year ago in spring 1994 and, following an initial period of research, has been discussed by the Board at virtually every one of its fortnightly meetings since then. However, the subject is complex and there are no obvious 'right answers'.

2.1 Why do a project?

The need for a project on financial instruments became apparent in three ways. First, comments received during the development of two other accounting standards—FRS 4 'Capital Instruments' and FRS 5 'Reporting the Substance of Transactions'—indicated the need for a wider project on financial instruments and, in particular, for a standard that would deal with accounting for derivatives. Secondly, from discussions with other national standard-setters and the International Accounting Standards Committee it became clear that this is a topic of international concern where all the leading accounting standard-setters need to work together. Thirdly, some of the recent well-publicised 'disasters' with derivatives have raised questions about whether accounting and disclosure practices could be improved.

2.2 Scope of project

Staff of the ASB initially spent some time talking to interested parties to identify the key concerns that might be addressed in an accounting standard. The Board has subsequently agreed that the project should address three main issues:

— disclosure, which should aim to give a structured 'big picture'. This reflects concerns that financial instruments and, in particular, derivatives, can transform a company's balance sheet and expose it to risks in ways that often are not made clear under present financial reporting practices.

— measurement, essentially the use of current values vs. historical cost. This reflects concerns that the traditional and long-established practice of measuring assets and liabilities at historical cost may not be the most appropriate measurement basis for at least some financial instruments.

— hedge accounting, particularly hedges of future transactions. This reflects concerns that, under present practice, hedge accounting can be used to defer the recognition of gains and losses in situations where this is may not be appropriate.

It has also become apparent that the project should not focus on derivatives in isolation but should encompass all financial instruments (including all borrowings and all investments except holdings of capital in the reporting company's subsidiaries and associates). This is necessary since companies often use derivatives in conjunction with other financial instruments to manage the risks that arise from their business operations or the funding of those operations. To address derivatives alone would be to look at only one side of the coin.

2.3 Work to date

The Board's project is still in its early stages: no final decisions have yet been taken nor have any proposals been issued. It is expected that a Discussion Paper, setting out the main issues and possible ways forward, and indicating the Board's preferred approach, will be issued for public comment in the first half of 1996.

Discussions so far have focused on the second of the three main issues noted above namely measurement of financial instruments. This issue was tackled first because the extent to which hedge accounting is required (if at all) and what disclosures are appropriate both depend on how financial instruments are measured.

The Board is currently exploring an approach whereby all financial instruments would be measured at current value (commonly referred to as 'marking to market'). Some of the changes in value would be reported in the profit and loss account and others in the statement of total recognised gains and losses. More details of this and other alliterative approaches that have been rejected are given at Annex II.

2.4 Consultation arrangements

The Board follows due process in drawing up all accounting standards. This normally involves issuing a Discussion Paper (which sets out the main issues and possible ways forward and, where possible, indicates the Board's preferred approach) and one or more exposure drafts (ie draft accounting standards) for public comment before proceeding to a standard itself.

In addition, for each of the Board's projects, a group of consultants is formed at the earliest stage to help identify issues and develop proposals. The consultants have a particular expertise and interest in the project and are drawn from a range of constituents including companies, auditors, users of accounts and academics. We also hold regular update meetings with representatives from each of the six largest firms of accountants, the Hundred Group of Finance Directors, the Institute of Investment Management and Research and various other organisations.

In the area of financial instruments, it is important that we keep up to date with related developments elsewhere. To this end we have had informal meetings with representatives of the Bank of England, the Securities and Futures Authority and the Securities and Investment Board.

Finally, we need to keep abreast of international developments. Section 3 outlines our work in this respect.

3. PROJECTS BY OTHER STANDARD-SETTERS

Several other accounting standard-setters have projects on financial instruments: they include those in Australia, Canada and the USA, as well as the International Accounting Standards Committee (IASC).

Representatives of these four standard-setters and the Board meet three times a year to discuss, and develop common solutions to, issues of mutual interest. Financial instruments is a high priority topic for all five bodies and one on which we are having continued discussions.

Progress to date by each individual standard-setter is briefly described below.

Australia

The Australian Accounting Standards Board (AASB) is nearing issue of a standard on disclosure of financial instruments that is broadly compatible with that of the IASC (see below). Following adverse comment on its proposals on measurement and hedge accounting, the AASB has decided to suspend further work on these aspects until other standard setters, including the IASC and the ASB, have further addressed them.

International Accounting Standards Committee (IASC) and Canada

The IASC and Canada have been working on parallel projects, with a shared staff resource for some years. Each has issued two draft standards, the first in September 1991 and the second in January 1994, which addressed disclosure, measurement and hedge accounting as well as some other issues[5]. In May 1995, the IASC issued a standard on disclosure and Canada expects to issue a very similar standard shortly. However, in the light of the adverse comments received on the proposals on measurement and hedge accounting, both standard-setters have decided to delay issue of a standard on these aspects pending further research and consultation. The IASC has just formed a new Steering Committee and Advisory Group to take the project forward, membership of which includes the ASB project director responsible for its financial instruments project.

USA

The Financial Accounting Standards Board (FASB) began a project on financial instruments in 1986. It has so far issued two Discussion Memoranda, a Research Report on hedge accounting issues, a Report on Deliberations, seven accounting standards on various disclosure aspects and an Interpretation on offsetting. Of the seven accounting standards, only the most recently issued—FAS 119: 'Disclosures about Derivative Financial Instruments and Fair Value of Financial Instruments'—deals specifically with derivatives and, as its title suggests, is limited to requiring certain disclosures. As regards the measurement of derivatives and hedge accounting, the FASB has been considering these aspects since January 1992 but has yet to reach a consensus. ASB members and staff are in regular contact with those from the FASB with a view to learning from each other's experiences and developing solutions that are broadly consistent.

4. THE BBA'S SORP

Normally, UK accounting standards apply to companies generally, not merely to selected industries or sectors. Accordingly, the Board's project on financial instruments is intended to result in an accounting standard that will apply to the generality of companies (including end-users) and not only to banks and other financial institutions. However, within the confines of accounting standards, it is open to industries to produce their own accounting guidance, referred to as 'Statements of Recommended Practice' (SORPs). To qualify as a SORP, the body seeking to develop it has to be approved by the ASB for that purpose and must follow the ASB's code of practice (eg the SORP working party must include representatives from a variety of constituents including auditors and users of accounts and a draft SORP must be issued for public comment). If the ASB is satisfied, it will issue a 'negative assurance' statement on the SORP to the effect that the SORP does not conflict with any existing or currently contemplated accounting standard or contain any fundamental points of principle that are unacceptable.

SORPs are not recognised by the Companies Act and do not have the same legal status as accounting standards[6]. However, they are seen as best practice within the industry concerned and are generally followed by the leading companies within their scope.

The British Bankers Association (BBA) and the Irish Bankers Federation (IBF) issued a SORP on 'Off Balance Sheet Instruments and Other Commitments and Contingent Liabilities' in November 1991, which required some, albeit limited, disclosures of the derivatives held by banks. In the light of a growing public perception that derivatives merit greater disclosure in a bank's financial statements, the BBA is in the process of revising this SORP to require increased disclosure of derivatives. It is also taking the

[5] These other issues were the distinction between debt and equity, separate accounting for the debt and equity components of hybrid instruments such as convertible debt and offsetting. The ASB has addressed all of these issues in two recently issued standards, FRS 4 and FRS 5.

[6] This status is described in Annex I.

opportunity to review the accounting principles on which the SORP is based and to update the SORP for two recently issued ASB standards, namely FRS 4 and FRS 5. The BBA hopes to issue a draft of the revised SORP shortly for public comment. The ASB project director responsible for its financial instruments project is an observer on the BBA SORP working party.

Annex I—The role of the ASB

This Annex describes the role of the ASB and the status of the standards that it produces.

The ASB is an independent private sector body whose role is to make, amend and withdraw accounting standards. Accounting standards are authoritative statements of how particular types of transaction and other events should be reflected in financial statements. By statutory instrument the Secretary of State for Trade and Industry has prescribed the Board for the purposes of section 256(1) of the Companies Act 1985 with the effect that statements of standard accounting practice issued by the Board are "accounting standards" for the purposes of the accounting requirements of the Act. The Board is autonomous; it needs no external ratification of its decisions. It is however the practice of the Board to consult widely on all its proposals.

The Companies Act requires companies' annual accounts to show "a true and fair view". Accounting standards are applicable to financial statements of a reporting entity that are intended to give a true and fair view of its state of affairs at the balance sheet date and of its profit or loss (or income and expenditure) for the financial period ending on that date. Compliance with accounting standards will therefore normally be necessary for financial statements to give such a true and fair view. Under the Act, large companies and groups are required to state in their accounts whether they have been prepared in accordance with applicable accounting standards and to give particulars, with reasons, of any material departure from those standards. The Board's sister body, the Financial Reporting Review Panel, has been authorised by the Secretary of State for the purposes of section 245B of the Act to examine departures from the Act's accounting requirements including applicable accounting standards and if necessary to seek an order from the court to remedy them.

Annex II—Further details of the ASB's work on financial instruments

As noted in Section 2.3 above, the Board's discussions in its financial instruments project have so far focused on measurement. The Board has considered the following possible broad approaches and, for the reasons set out below, currently favours approach (e):

(a) *measuring all financial instruments at historical cost.* With the exception of portfolios traded by banks and other financial institutions, this is basically the current position. It is widely regarded as unsatisfactory for a number of reasons, which are accentuated by the readily realisable nature of financial instruments. Some of the drawbacks of historical cost are that: including gains and losses in the accounts only when realised in cash results in a profit number that does not reflect events of the year in question and may lead to unrealised gains and losses (and potential disasters) being overlooked; it enables abuses such as 'cherry picking' sales to report a chosen level of profits; and it gives rise to a need for hedge accounting, which involves many conceptual and practical problems.

(b) *measuring only some financial instruments at current value and others at cost.* The Board initially explored a proposal along these lines which would have distinguished two types of company. The historical cost basis would continue to be used by a 'simple' company that held its fixed rate debt to maturity and used only straightforward derivatives (eg interest rate swaps) as one-to-one hedges of that debt. Conversely, a company that 'actively managed' risk by buying and selling financial instruments in response to market movements would measure its financial instruments at current value. The Board rejected this approach because of objections raised by consultants and the impossibility of drawing a sensible distinction between instruments measured at cost and those measured at current value. One particular concern was that the approach might discourage companies from becoming more sophisticated and moving from being a 'simple' company to 'actively managing' risk because of the accounting consequences of doing so.

(c) *measuring all financial instruments at current value in the balance sheet and reporting all changes in value in the profit and loss account.* Some regard this as the best solution because (i) they believe that conceptually the best measurement basis is current values; and (ii) it avoids the need to make distinctions as to which gains and losses should be recorded in the profit and loss account and which elsewhere. However, such an approach would probably prove unacceptable in practice owing to the volatility of profits that would result. In particular, people object to recording unrealised gains and losses on fixed rate borrowings[7] in the profit and loss account. They believe that such gains and losses are not relevant unless the company intends to redeem the borrowing and realise the gain or loss and that recording them in the profit and loss account gives volatile profits that imply that fixed rate debt is risky when this is not the case. They also point out that, in the absence of default or early repayment, gains and losses on fixed rate debt

[7] ie the change in the value of a fixed rate borrowing that occurs when interest rates change.

will reverse by maturity. For example, if a company borrows 100 for two years at a fixed rate of 10 per cent and, at the end of year 1 interest rates fall to 5 per cent, the value of the borrowing will rise to 105[8]. However, by the end of year 2 when the borrowing matures, its value will revert to 100, being the amount that must be repaid;

(d) *measuring all financial instruments at current value in the balance sheet but deferring gains and losses that result from changes in value in a balance sheet caption (either within assets and liabilities or a separate component of shareholders funds) until some future time (such as sale or maturity of the instrument).* This has the disadvantage that gains and losses are not reported in a performance statement in the year they occur, with the consequent problems and opportunities for abuse outlined in (a) above. In addition, it results in items in the balance sheet whose meaning is unclear: deferred losses and gains are not assets and liabilities and if they are reported as such this has the anomalous result that a larger deferred loss will give rise to larger assets and a larger deferred gain to larger liabilities[9]. The alternative of reporting such deferred gains and losses as a separate component of shareholders funds amounts to 'reserve' accounting', whereby recognised gains and losses by-pass the profit and loss account and, as a result, may be overlooked.

(e) *measuring all financial instruments at current value, but recording some of the changes in value in the statement of total recognised gains and losses ('STRGL') and others in the profit and loss account.* The STRGL is a second statement of performance, introduced by the ASB in 1992, to highlight those gains and losses that previously were hidden in reserves (an example being the currency losses suffered by Polly Peck). Two main items currently appear in the STRGL: gains from revaluing fixed assets and differences arising on translating into sterling the net assets of an overseas operation. If financial instruments were measured at their current value, the STRGL might also report certain gains and losses arising on financial instruments. In particular, the STRGL might report gains and losses on fixed rate borrowings and derivatives whose terms substantially match those of an underlying borrowing: the profit and loss account would then show all other gains and losses on financial instruments. This approach has the advantages of getting the balance sheet number 'right'; of recording all gains and losses in a performance statement in the year that they occur and thereby avoiding the problems and opportunities for abuse outlined in (a) above; and of avoiding the volatility of profits that would result from recording all gains and losses in the profit and loss account. The main difficulty comes in drawing distinctions between the gains and losses to be reported in the profit and loss account and those to be reported in the STRGL. The Board is currently exploring this approach and the issues it raises.

9 June 1995

APPENDIX 7

Memorandum submitted by the Bank of England

BANK OF ENGLAND ENFORCEMENT ACTIVITIES

INTRODUCTION

1. As part of the implementation of financial services legislation, the Bank of England has been given a number of powers and responsibilities under the Banking Act 1987, many of which were also laid on the Bank in the previous Act in 1979. As well as prosecuting illegal deposit-taking, the Bank "enforces" legal deposit-taking through the authorisation process, and more particularly through its ability to remove directors, controllers or managers, or to restrict or revoke an institution's authorisation. The Banking Act also permits the Bank to share "enforcement" information with other supervisors and regulators.

BANKING ACT OFFENCES

2. The Director of Public Prosecutions and the Bank are the two designated prosecuting authorities for offences under the Banking Act 1987. These offences include carrying on a deposit-taking business without authorisation (Section 3), and fraudulently inducing another person to make a deposit (Section 35). The Bank has a group of 10 individuals employed full time on investigating, and where appropriate prosecuting, such illegal activity. A number of prosecutions have been made under the Banking Act 1987

[8] ie the borrowing is now more onerous. This reflects the fact that the company is obliged to pay 10 per cent at a time when market rates are only 5 per cent. As a consequence, if the company wished to redeem the borrowing at the end of year 1, it would have to pay 105 to do so.

[9] for instance, in the example above at the end of year 1 the borrowing would be revalued to 105 and a deferred loss of 5 would be included within assets despite the fact that the company is now worse off.

(and under the previous Act of 1979); the attached Appendix summarises recent cases and their outcomes.

3. The number of cases being investigated by the Enforcement Group is reported each year in the Banking Act Annual Report. In recent years, the number of separate cases under review were as follows (some cases can extend over two or more years):

Year to end February	
1995	52
1994	43
1993	30
1992	37
1991	26

4. Civil action against those engaged in illegal deposit-taking is also brought from time to time. Such action will typically be injunctions to restrict the disposal of the assets of the person concerned and to restrain further deposit-taking and sometimes to petition for the winding up of the company concerned. The number of cases where such actions have been brought in recent years is:

Year to end February	*Injunctions*	*Winding up Petitions*
1995	2	–
1994	–	–
1993	2	2
1992	3	1
1991	4	–

5. The Bank has power under section 42 of the Banking Act to require the production of documents, information and answers to its investigators. These powers have been used as follows:

Year to end February	*Number of new cases*	*Number of notices served*
1995	19	68
1994	12	71
1993	11	41
1992	21	42
1991	16	69

6. Offences are also established by the Banking Act where a banking name or banking description is used otherwise than in the circumstances permitted by Sections 67 and 69 eg by an authorised institution. It is also an offence under Section 94 of the Act knowingly or recklessly to provide the Bank of England with information which is false or misleading in a material particular, to withhold or fail to provide information relevant to its functions, or which is likely to result in the Bank being misled. The Bank has prosecuted under Sections 67/69 and Section 94 on a number of occasions, and these are included in the statistics in the attached Appendix.

FITNESS AND PROPERNESS/PRUDENT CONDUCT

7 In its "enforcement" of its supervisory responsibilities, the Bank can also restrict or remove an institution's authorisation, in accordance with Sections 11–14 of the Banking Act. The existence of these powers means that the Bank has extensive de facto ability informally to require institutions, where appropriate, to change, or refrain from, courses of action which it considers to be against the interests of depositors. No separate record is kept of the number of occasions in which remedial action is agreed on a voluntary basis since it is a not uncommon occurrence; but this is perhaps the Bank's most effective enforcement instrument and its use has become more frequent as the Bank has adopted a more vigorous and enquiring supervisory stance in recent years.

8. The Bank may revoke the authorisation of an institution, inter alia, if it has reason to believe that any of the authorisation criteria set out in the Act is not, or may not be, fulfilled; these criteria include requirements that directors, controllers and managers of an institution are fit and proper, and that the institution's business is conducted prudently. Exercise of the Bank's powers under Section 11–14 of the Act are referred to in the Bank's Banking Act Annual Report. The number of occasions each power has been used in recent years are as follows:—

REVOCATIONS AND RESTRICTIONS[1]

Year to end-February	*1991*	*1992*	*1993*	*1994*	*1995*
Revocations of authorisation[2]	3	1	3	1	–
Restriction of authorisation	4	4	12	7	1
Revocation of restricted authorisation	–	–	2	–	–

(1) The table only relates to institutions authorised under the Banking Act. It records cases in the year that the Bank's formal notice of revocation or restriction was given. In some cases the revocation did not take effect until the following year and in a few cases the institution surrendered its authorisation, or a conditional authorisation expired, before the revocation took effect. It is not therefore a record of authorisations revoked or restricted but of the use of the Bank's powers.

(2) Including the expiry of a time limited authorisation.

LIAISON WITH OTHER REGULATORY, AND OTHER, BODIES

9. As well as exercising its powers under the Banking Act on its own account, the Bank is permitted under Part V of the Act inter alia to disclose information to other supervisory bodies and regulatory authorities for the purpose of enabling those bodies to carry out their proper functions. Such disclosure is routinely made to other regulators which also supervise particular institutions; this may be on an ad hoc basis, or at regular meetings between regulators. Where matters falling within the province of the police or other prosecuting authorities come to its notice, the Bank contacts those authorities as a matter of general practice and unless there is very good reason not to do so.

10. The Bank is a founder member of the Financial Fraud Information Network (FFIN), and the Head of the Bank's Special Investigations Unit is FFIN's first chairman. Membership consists of some twenty agencies including government departments, regulators and supervisors, investigators and prosecutors. FFIN is a forum in which the Bank exchanges information as necessary with those other agencies, about possible cases of major financial fraud and other serious criminal activity. Disclosures within FFIN may be in respect of authorised institutions or in respect of other persons engaged, or potentially engaged, in fraud within the financial system.

11. Although as a matter of practice most of the Bank's resources in this area are involved on domestic activities, contact is maintained with regulators in other countries, both on a bilateral basis where necessary and appropriate, and through regular international fora such as the EU Groupe de Contact, the Basle Committee on Banking Supervision, the EU Banking Advisory Committee and the EMI Supervisory Sub-Committee.

26 June 1995

BANKING ACT PROSECUTIONS

Year	*Prosecutor*	*Name & Amount*	*No of counts*	*Section*	*Plea*	*Court*	*Sentence*	*Comments*
1989	Bank	Derbyshire (Yield & Growth Investments) £350,000	6 6	S.3 S.1 (1979 Act)	Guilty Guilty	Nottingham Crown Court	18 months' imprisonment 14 of which suspended	Reduced on appeal to 6 months' all suspended for 2 years. (Derbyshire served most of sentence before appeal).
1991/92	Bank	Riley (YOD) £1.1mn	6 3 2	S.3 S.35 S.94	Guilty {2 Guilty {1 N. Guilty Guilty	Knightsbridge Crown Court	2½ years' imprisonment on S.35s & 1 year concurrent on each S.3 & S.94	Remaining S.35 count left on file (S.35 counts all "knowingly")
1991/92	Bank	Horsman (Authority)	2	S.94	Guilty on one count	City of London Magistrates	£1250 fine + £250 costs	Second S.94 count dropped.
	Bank	Woodford (Authority)	2	S.94	Guilty on one count	City of London Magistrates	£500 fine + £100 costs	Second S.94 count dropped.
1992/93	Bank	Chesworth £2mn	18	S.3	Guilty	Preston Crown Court	1 year imprisonment on each count to be served concurrently	

BANKING ACT PROSECUTIONS— *(continued)*

Year	*Prosecutor*	*Name & Amount*	*No of counts*	*Section*	*Plea*	*Court*	*Sentence*	*Comments*
1992/93	Bank	Cotton £30,000	9	S.35	Guilty in respect of 5 of the counts. The other 4 were struck out.	Birmingham Crown Court	9 months' imprisonment on 1 "knowingly" count and 6 months' on "reckless" concurrent.	
1992/93	SFO	Bowyer (McColl & Crow) £2mn	1	S.3	Guilty	Southampton Crown Court	Conditional discharge	Judge considered his loss of face, bankruptcy and loss of his practice sufficient punishment.
1993/94	CPS (FIG)	O'Kelly (Foulkes Ingram & Co)	2	S.1(1) Criminal Law Act (Conspiracy)	Guilty	Cardiff Crown Court	3 years' imprisonment on each conspiracy count and 9 months' on each Banking Act count, all concurrent.	Prosecution agreed not to proceed to trial on 2 "not guilty" counts.
			1	S.1(1) Prevention of Fraud Investment Act 1958	N. Guilty			
		£2.3mn	1	S.1 Banking Act 1979	Guilty			
			1	S.3 Banking Act 1987	Guilty			
			1	S.3(1) and 2 FSA 1986	N. Guilty			
			4	S.15(1) Theft Act	Struck Out			

BANKING ACT PROSECUTIONS— *(continued)*

Year	*Prosecutor*	*Name & Amount*	*No of counts*	*Section*	*Plea*	*Court*	*Sentence*	*Comments*
1993/94	CPS (FIG)	Turner (Foulkes Ingram & Co)	2	S.1(1) Criminal Law Act (Conspiracy)	Guilty	Cardiff Crown Court	3 years' imprisonment on each conspiracy count and 9 months' imprisonment on each Banking Act count all concurrent.	Prosecution agreed not to proceed to trial on 2 "not guilty" counts. Turner was terminally ill with cancer on sentencing on 20 July '93 and died in Cardiff Prison in September '93.
			1	S.1(1) Prevention of Fraud Investment Act 1958	N. Guilty			
			1	S.1 Banking Act 1979	Guilty			
		£2.3mn	1	S.3 Banking Act 1987	Guilty			
			1	S.3(1) and 2 FSA 1986	N. Guilty			
			4	S.15(1) Theft Act	Struck Out			
1994/95	Bank	Pecunia International Limited	3	S.69	Guilty	East Dereham Magistrates	£500 fine on each count	
1994/95	Bank	Amy Meyer (Pecunia International Limited)	1	S.69	Guilty	East Dereham Magistrates	£50 fine + £50 costs	
1994/95	Bank	Susan Meyer (Pecunia International Limited)	2	S.69	Guilty	East Dereham Magistrates	£300 fine on one of the two counts + £50 costs	

BANKING ACT PROSECUTIONS— *(continued)*

Year	*Prosecutor*	*Name & Amount*	*No of counts*	*Section*	*Plea*	*Court*	*Sentence*	*Comments*
1994/95	CPS (Newcastle)	Aspinall £1mn	9	S.35	{7 Guilty {2 N. Guilty	Newcastle Crown Court	6 months' imprisonment on each S.35, 3 months' imprisonment on each S.3, all concurrent.	The 7 S.35 counts on which Aspinall pleaded guilty were offences. "Reckless". The "not guilty" counts were not proceeded with.
			3	S.3	Guilty			
			3	S.15 Theft Act	Struck out			
1994/95	CPS (FIG)	Finnegan (North of England Inv.)	2	S.3	N. Guilty	Middlesbrough Crown Court	Both sentenced to 1 years' imprisonment on each of counts 6, 7 & 8 all concurrent. Additionally Finnegan 1 year on count 4, and Braund 1 year on each of counts 3 & 10, both concurrent. (Each to serve a minimum of 2 years). Both also disqualified from directorship for 12 years	Judge instructs jury to return not guilty verdict on S.3 counts.
			8	S.35	N. Guilty			
	CPS (FIG)	Braund (North of England Inv.)	2	S.3	N. Guilty			Judge instructs jury to return not guilty verdict on S.3 counts.
		£750,000	8	S.35	N. Guilty			

BANKING ACT PROSECUTIONS— *(continued)*

Year	*Prosecutor*	*Name & Amount*	*No of counts*	*Section*	*Plea*	*Court*	*Sentence*	*Comments*
1994/95	Bank	Everett (Sector Leisure Ltd) £190,000	12	S.35	{8 Guilty {4 N. Guilty	Exeter Crown Court	2 years' imprisonment on counts 5 & 6; 1 year on count 1; 9 months' on count 2; 9 months' on counts 10 & 12 and 3 months' on each of counts 4 & 8, all concurrent (minimum of 2 years)	Sentence reduced from 2 years to one year on appeal on 27.4.95. Appeal judges considered that trial judge had not taken account the fact that Everett was reckless rather than dishonest.

BANKING ACT PROSECUTIONS— *(continued)*

Year	*Prosecutor*	*Name & Amount*	*No of counts*	*Section*	*Plea*	*Court*	*Sentence*	*Comments*
1994/95	Bank	Reuben Lawrence (Sylcon Finance Ltd)	5	S.3/96(1) "Consent"	N. Guilty	Snaresbrook Crown Court	Both sentenced to 6 months' imprisonment on each count to be consecutive giving a total of 2½ years. Sentence reduced on appeal on 10.5.95 to 6 months for each of two counts consecutive and 6 months for each of three counts concurrent giving total of 12 months for each man.	Not guilty verdicts recorded on "consent" charges. S.458 charges are to remain on court file. Note: charges under S.44(1) relating to the concealment of documents were thrown out by magistrate at committal.
			5	S.3/96(1) "Neglect"	Guilty			
			1	S.458 Companies Act "Fraudulent Trading"	Dropped by Bank			
1994/95	Bank	Reuben Ian (Sylcon Finance Ltd)	5	S.3/96(1) "Consent"	N. Guilty			
		£2.5mn	5	S.3/96(1) "Neglect"	Guilty			
			1	S.458 Companies Act "Fraudulent Trading"	Dropped by Bank			

BANKING ACT PROSECUTIONS— *(continued)*

Year	*Prosecutor*	*Name & Amount*	*No of counts*	*Section*	*Plea*	*Court*	*Sentence*	*Comments*
1995/96	SFO	Yar Ahmad Khan (General Credit Finance)	4	S.35 "recklessly"	N. Guilty	Southwark Crown Court	Sentenced to 3 years' imprisonment on each count to run concurrently	Khan was very much the secondary figure. Hasan is still abroad and to be tried if he returns.
			1	S.458 CA85 fraudulent trading	N. Guilty			
		£750,000	25	Variety	Not proceeded with			

APPENDIX 8

Memorandum submitted by BAT Industries plc

THE FUTURE REGULATION OF RETAIL FINANCIAL SERVICES

1. INTRODUCTION

We welcome this opportunity to submit our views on the future of retail regulation. We believe that the current system of regulation by prescription is flawed and describe in this paper the principles and practices which we believe are essential to the long-term viability of any system of regulation for retail financial services.

We have consistently subscribed to the view that a single regulator for retail financial services, based on clearly defined principles, is in the interests of both the industry and investors. When we expressed our views on this subject in February 1994, the process of creating the Personal Investment Authority was well advanced. Despite widely held misgivings concerning the structure and governance of PIA, it became impossible to resist the strong factional pressure to move ahead quickly. It was clear that more considered debate on the future shape of retail regulation would have to be deferred.

We welcome the statement by Andrew Large in a recent speech[10], recognising that the time has come to reopen the debate as to the degree of prescription necessary for good regulation. We believe that such a debate must necessarily encompass a much wider range of issues, including fundamental questions about the scope, culture and structure of both regulation and regulators. We should strive for a new consensus, based on a thorough analysis of the experience of regulation to date and the emerging challenges of the rapidly changing marketplace. Recognising that the outcome may require legislation, we believe that it is timely to begin discussions now, in order that decisions can be implemented within the next Parliament.

This paper outlines the principles and practices that we believe are essential to the long term viability of any system of regulation for retail financial services. It suggests two alternative structures that could embody them. We advance these proposals as an opening contribution to the new debate.

2. THE DEVELOPMENT OF REGULATION

The issue of regulation of retail financial services has been a matter of continuous debate since 1982, when Professor Jim Gower published his "Review of Investor Protection—A Discussion Document"[11]. His subsequent report in 1984 proposed a new general framework for investor protection rules and their administration, alongside detailed recommendations covering insurance, unit trusts, take-overs and insider dealing. The essence of the proposals was the creation of a system of "self-regulation within a statutory framework", to be administered by a body largely independent of Government and staffed by practitioners. The "self-regulatory" element was to be balanced by the exercise of statutory powers by the Secretary of State. Professor Gower originally proposed that this statutory role should be fulfilled by the relevant department of Government, at the time the Department of Trade and Industry. He recognised that both practitioners and government had proper roles to play but did not define them clearly. Nor were they clarified in the subsequent consultation process, a flaw for which industry must take a share of the blame.

There were two other important flaws in the conclusions of the Gower review that have had a continuing malign influence on the subsequent structure and process of regulation that emerged.

Firstly, there was no requirement for mandatory cost-benefit analysis of regulatory proposals. In his review, Professor Gower rejected this, on the grounds that "I am not competent to undertake it and, partly, because I am sceptical about its practicality". In an industry where demand is price-elastic, the omission of a legally binding requirement for regulation to be cost-effective is a serious deficiency. This was compounded by the Government in 1987, when SIB was granted immunity from submitting its rulebook to the Enterprise and Deregulation Unit. It was not until 1993, with the Large report, that cost-benefit analysis was put on the agenda. Two years later no proper analysis of the current system has taken place, although the creation of the PIA would have provided an excellent opportunity. If this had happened, it is inconceivable that the PIA would have emerged in its present form.

The second serious flaw related to the responsibility of the regulators is in respect of competition policy. Gower believed that the regulator should be free from the discipline of competition provisions in domestic and European legislation, in order to pursue its function without the threat of constant litigation. He envisaged that this freedom would be balanced by a requirement that the Secretary of State should be

[10] "Disclosure: Past, Present and Future"—19 January 1995.

[11] Cmnd. 9125, HMSO, 1985, Parts 1 & 2.

satisfied that the rules of any regulator "Do not impose restrictions on competition greater than ... necessary for the protection of investors". If the regulator did not meet this requirement, its powers would be revoked. In practice, the constitutions of the SROs have enabled them to change their rules with a frequency that makes the exercise of such supervision difficult. Revocation, by its nature, is an extreme option which was never likely to be used.

The Office of Fair Trading has expressed its belief, on more than one occasion, that the rulebooks of the various regulators are anti-competitive, but has been overruled by the Secretary of State of the day. We do not believe this was what Gower intended.

The flaws in Gower's proposals were not addressed in the Financial Services Act 1986. The FSA altered Gower's recommendation that the Secretary of State should fulfil the "statutory" role and delegated this task to a new body, the Securities and Investments Board. The decision to set up a body separate from the DTI to fulfil the statutory role created a two-tier system, instead of the single tier originally envisaged. Additionally, neither the senior management of SIB nor the Self Regulatory Organisations (SROs) have ever been "staffed by practitioners", as suggested.

The SIB was the first regulator to have delegated statutory powers. Not surprisingly, the legislators wished to ensure maximum certainty. Accordingly, the form and structure of regulation that emerged from the Act introduced a system in which recognition of SRO's was based on their rulebooks. This process, which derived from the concept of "equivalence", directly led to detailed prescription and regulating for "best practice", rather than the minimum standards necessary for investor protection, for which the Act provided. To a large extent this obsession with prescription was encouraged by the industry, who were anxious for certainty in the event of legal actions under S.62 of the Act.

A system based on detailed rules, with no binding requirement to be cost effective and promote competition, has created an all-pervasive culture of prescription. Excessive reliance on prescription has also reduced the ability of regulation to respond to changes in the market. In turn, this reduces the incentive for innovation, to the detriment of consumers. These practices have become the heart of the culture of regulation and proved deeply resilient to any attempts at revision.

The Companies Act 1989 gave legal freedom partially to address these issues. The removal of the equivalence requirement responded to perceived over-prescription in SIB's rulebook, mainly in the wholesale sector. This led to the introduction of The New Settlement, in which SIB proposed a significant reduction in the degree of prescription in its rulebook.

There have since been a number of reviews of retail regulation, reflecting a persistent unease about the benefits delivered to the consumer and the effectiveness of regulation. Home Income Plans, Maxwell and the FOX scandals have contributed to this unease, as has the persistent inability of the IFA sector to fund their own regulatory costs and compensation. The most significant reviews were the Review of Retail Regulation[12], commissioned by SIB in 1989, and Andrew Large's report "Making the Two Tier System Work[13]", which was commissioned by the then Chancellor of the Exchequer in July 1992. The problem is that the terms of reference for each review have excluded the opportunity to propose any change to the regulatory structure which would require legislation.

The terms of reference for the 1990 Retail Review should have permitted consideration of a wide range of issues, including the scope of the Act in respect of retail products. In the event the review was restricted to marketing aspects and to investment products as defined by the Act, rather than including consideration of the deposit-based products that were emerging, in the eyes of the consumer, as competitors to regulated savings products.

As part of the Retail Review, regulatory concern over the operation of FIMBRA and, in particular, its viability as a separate SRO, prompted a study by Sir Kenneth Clucas[14]. His terms of reference included consideration of future possible regulatory structures, as well as the feasibility of a single SRO for the retail sector. This apparent freedom was restricted in practice by requirements to work "within the existing statutory framework" and to preserve "a wide choice of financial advice". This latter requirement was interpreted narrowly, as an instruction to preserve the current structure of the intermediary market. As such, the proposals for a single retail SRO were predicated largely on the need to continue funding IFA regulatory costs via cross-subsidies.

The PIA was very much a product of the restricted scope of Sir Kenneth Clucas's report:

— It sought only to improve on the practice already in place, rather than building on a clearly identified set of principles.

[12] SIB, March 1990.
[13] SIB, May 1993.
[14] SIB, March 1992.

— The regulatory scope of PIA was restricted to products and services covered by the FSA and currently manufactured and sold by members of the SROs to be merged. The range of products that compete in the eyes of the consumer is much wider than this, yet there was no consideration given to ensuring equivalence of regulation across the whole range of retail financial products.

— The existing arrangements for the prudential regulation of firms involved in the provision and marketing of retail financial products were not revisited. PIA simply assumed the prudential regulation of IFAs from the relevant SROs. The relationship between prudential regulation and the regulation of marketing activities was not considered.

— The issues of consistency of regulation and arbitrage, raised by the anomalous position of RPBs, were recognised but not resolved.

The Large report similarly confined itself to the objective inherent in its title, concentrating on addressing an incomplete list of criticisms levelled at the existing regulatory structure and process. It did not, for example, examine the issue of duplication of function between SIB and the other regulatory bodies, accepting the proposal for a single, second-tier retail regulator. Significantly, the report did raise the issues of regulatory costs, the need to focus on enforcement and prescription. Implementation of the actions it suggested has been slow. Andrew Large himself commented that the opportunity for reducing prescription offered by the New Settlement had not been taken up by the SROs. However, the SROs argue that this was actually discouraged by SIB. Whatever the reason, the underlying problem remains.

Prescription is a fundamental driver of both enforcement practice and regulatory costs. The failure to address the issue has prevented significant progress in either of these areas and strengthened the resilience of the established culture of governance by the rulebook.

The process of PIA's formation exacerbated the weaknesses of the reviews in a number of ways:

— The debate was heavily influenced by the concerns about funding the IFA sector. As a result, cross-subsidies were built into the cost structure. The PIA prospectus contained a commitment to end cross-subsidies on fees which is welcome. Proposals to implement this are still awaited.

— The need for the PIA to attract members speedily led to a process of compromise in which any radical re-examination of principles was prevented.

— The issue of governance was viewed principally as one of balancing factional interest and the need to preserve a semblance of "self-regulation".

— The perceived need for a "step change" in regulatory standards led to greater prescription, rather than less, as new rules were measured against "highest existing standards" without demonstrating whether these were appropriate.

As a consequence, the PIA is flawed in its internal structure, its constitution and in its position within the regulatory framework. We question the extent to which these flaws are likely to be corrected within the current structure, given the regulatory culture that has evolved over the last decade. It was, and still is, our belief that change is necessary to provide the levels of investor protection to which Government and the industry aspire, while maintaining an environment in which UK firms can compete fairly, both within the UK marketplace and more widely.

3. What Does the Future Hold?

In considering the shape of future regulation, we need to understand more than simply how we got to where we are in terms of the history of our regulatory system. We need also to understand the marketplace we are seeking to regulate. In the decade since the FSA was passed, there has been unremitting change in the industry, in the product range on offer, in society itself and consequently in consumer expectations and behaviour. It is important to give due consideration to past, and likely future, changes in considering the optimum shape of future regulation.

The range of retail packaged products has grown significantly. This is partly as a result of government innovation to increase individual share ownership and partly as the industry has responded to new market needs, consequent on the gradual withdrawal of universal state provision. TESSAs, PEPs, deposit-based guaranteed products, many health and long term care products, are but a few of the more familiar new products. More will come on stream in the next decade. It is unlikely that individual consumers make a clear differentiation between deposit and securities-based products when deciding what to do with their savings, yet both the regulatory and tax structures still presume they do. It is also likely that savings products will compete increasingly with protection products, as alternative means of filling the gap left by retreating state provision. The market determinator of the regulatory system must reflect these changes to ensure that consumer choices are informed.

There is a growing practice of cross-selling between investment, credit, life and general insurance products. As providers seek to differentiate their offering in an over-crowded market, they will develop brands and build a portfolio of products to cover the consumer's complete personal finance needs. While this trend may be influenced by European Union rules, the ability to handle all of a client's savings, credit and insurance needs within a single business is likely to develop strongly.

Developments in Information Technology make it easier to create flexible packaged products that can be tailored to the individual's needs and aspirations and altered, for a fee, when the individual's circumstances change. These trends will drive the industry away from the solely commodity-based end of the market. Competition will focus on significantly increased personal choice through value added products, sold on perceived value for money.

We can expect continuing evolution in distribution channels. The advent of secure systems for multi-media selling and money transfer will enhance the opportunities for the comprehensive offering, including home banking. This will also increase cross-border selling.

The existing structure of distribution through advisers is likely to change. When the FSA was passed, the legislators expected that Banks and Building Societies would act as IFAs selling several providers' products. Instead, many of the Banks and Building Societies became tied agents. More recently, they have entered the market, or announced plans to enter the market, as providers themselves.

The number of small IFAs has shrunk significantly and is set to shrink further. The growth in Networks and mergers between small IFAs is evidence of this trend.

The problems associated with the selling of personal pensions are accelerating this trend. This will be particularly true if the SIB/PIA Guidelines lead to legal actions by those entitled to compensation, since this will have a harsh effect on the IFA. Ultimately the costs of pensions mis-selling will have a once-off impact. Higher entry standards and training and competence requirements will have a more lasting effect.

The current distinction between "Tied" and "Independent" status is likely to be redefined, in both marketing and financial terms. In future, the legal definition of independence may require the absence of economic ties to a provider, such as commission. It may also require the capacity to advise across the whole market. Although IT can help, this capacity is likely to be limited to larger firms. Independent intermediaries will have to demonstrate resources adequate to fund civil liabilities arising from the advice they give, as well as reasonable provision against financial collapse. Ironically, the more that regulation seeks to maintain the independent sector artificially via cross-subsidies, the more it undermines its independence and contributes to its demise.

The number of financially independent, fee based IFAs will increase slowly. Competitive pressures may lead to the introduction of some form of general agency status, which gives intermediaries freedom to advise on the products of a number of providers, provided that those providers take responsibility for advice in respect of their products.

The consumer is also changing. Consumers are generally more confident in, and demanding of, their rights, perceived and real. This has yet to feed through to the generations buying insurance and investment products. In the market for retail investment and savings products the famous "sold not bought" tag is becoming less true. It is reasonable to argue that products which protect the consumer during his life, such as critical illness and pensions, increasingly are "bought" while products that provide for his dependants after his death are still more likely to be "sold". Evidence from a variety of sources[15] shows that there is a much higher awareness in the population generally of the need to make personal provision for their pension, old age care and, to a lesser degree, for health and unemployment. Younger age-groups, in particular, expect to make such provision and do not believe the State will provide for them adequately. They expect to pay fair charges as part of the price of the products they buy. Yet it must be recognised that the consumers' ability to decide what type of protection and investment products he wants or needs is severely hindered by a lack of education. There is a serious deficit in the basic understanding among the population at large of retail investment, insurance and protection products and the concepts underpinning them.

At the same time, there is a growing consensus that the State cannot continue to fund, at the level its citizens expect, needs such as retirement income, long term care and sickness from general taxation. As Government withdraws from State provision, it has a duty to provide the education needed to enable the public to understand the options available to them. Action by Government, through the Department of Education in partnership with the industry is urgently required. Viewed as an adjunct to regulation, this will do more to improve consumer protection and ensure a greater degree of professionalism amongst advisers than regulation will ever be able to achieve on its own. An educated consumer is the most effective mechanism for securing high standards at the point of sale in a competitive industry.

[15] Coopers and Lybrand/NOP—Dec 1994, LAMRA, Allied Dunbar 1994.

More generally, there is an increasing public expectation of transparency and openness, both in commerce and in the processes of Government. Future confidence in regulation will require that this principle is embraced.

4. The Implications for Regulation

The marketing of retail financial products is subject to the general law in respect of, inter alia, solvency, agency, contract and consumer protection. It is therefore necessary first to consider why any regulation is necessary in addition.

Firstly, these products are unique in their intimate relationship with the quality of the purchaser's life. Any flaw in the benefit purchased is usually only apparent when it is too late to make an alternative purchase. Secondly, the existence of provision through retail products contributes to social stability. These, rather than any other considerations, provide the rationale for legally enforced consumer protection, over and above that applied to the sale of goods and other services. When combined with the relative lack of expertise of the purchaser, these factors also define an essential difference that must prevail between regulation of the retail and wholesale, or professional, markets. The nature of regulation must focus on these unique features of retail financial services.

Customer education and transparency of competing products will be complementary elements in enabling the majority of consumers to make informed choices and this will be of increasing importance in determining the shape of regulation. The complexity of balancing long and short-term needs and planning for uncertainty in their working lives will mean that more advice will be tailor-made, ensuring that the role of the adviser remains a key part of many purchases. More educated consumers, who are increasingly aware of the need for personal provision, will demand more professionalism from their adviser. The minimum levels of competence and skill to be expected of advisers will therefore remain a key consideration. Over and above this, a high level of professionalism will be a key determinator of success in the marketplace.

Innovation in product design, associated with the use of financial instruments of increased complexity, will increase the need for prudential regulation of a wide spectrum of providers, marketing overlapping product ranges. Prudential regulators will need to ensure consistency across the market by relating the requirements they impose to the nature of the risk or product involved, rather than the institution they are regulating, in order to maintain fair competition. The structure for marketing regulation must embrace all competing products, rather than maintaining an arbitrary split based on the underlying investment medium, or product purpose, as at present.

The overall cost burden of regulation and the way it is distributed among providers, intermediaries and general taxation will be of considerable significance to competition within the UK and the competitiveness of the UK as a base for financial services companies. The establishment of common EU rules for marketing retail insurance, investment and banking products will enlarge the number of both product offerings and product providers despite continuing tax differentials. It will also permit market entry based on different home country regulations. This is likely to be to the advantage of those countries with the most cost-effective and flexible regulation. Member States, such as the UK, that maintain artificially high barriers based on prescriptive, supra-legal market regulation must anticipate finding themselves subject to EU scrutiny, and possible legal challenge, as EU rules develop the definition of "the general good". Simultaneously, they risk disadvantaging their own companies in developing their markets outside the UK, whether in the EU or in third countries, through the reduced flexibility and increased cost imposed by over-prescription.

Regulation must recognise and monitor changes in these factors, achieving a balance of rights and responsibilities between providers, intermediaries and consumers. The responsibility on the industry to achieve greater professionalism, consistency and relevance of product information is one which should be matched by an environment in which the burden of a prescriptive regime is lifted. Regulation can then be focused on policing those who do not fulfil their responsibility, with penalties that act as an effective deterrent.

5. The Scope of Future Regulation

Professor Gower's words on the purpose of regulation still hold good—"Regulation ... should be no greater than is necessary to protect reasonable people from being made fools of".

The objective of retail regulation should be to set the minimum standards necessary to ensure that a responsible consumer can purchase any packaged product with equal confidence, regardless of the distribution outlet from which he or she chooses to buy. Having set the necessary standards, the regulator must ensure they are complied with fully. Rules should be directed solely at clarifying the standards to be achieved. The methods by which a company meets those standards should be left to the company to determine. The adoption of standards above the minimum level necessary for the protection of the consumer is a matter for competition between individual firms to decide and not the proper concern of the regulator.

The scope of regulation must cover four essential areas:

— *Financial Probity*—The financial probity of both providers and retailers of financial products and services is central to investor protection. It meets the central requirement for consumer protection against that which the consumer cannot reasonable know. The issue of financial probity applies differently to providers and intermediaries. In the case of investment managers and providers, it relates to having adequate recourse to capital to ensure the prudent, long term stewardship of investors assets in accordance with contractual obligations and the financial capacity to compensate investors in the event of bad advice.

In the case of an intermediary, financial probity also relates to demonstrating freedom from any malign influence that financial pressure may have on selling practices. To avoid unnecessary barriers to competition, "adequate recourse to capital" for intermediaries may involve a combination of financial resources and suitable professional indemnity insurance. Where an intermediary wishes to hold himself out as "independent", it should also involve demonstrating financial independence from providers.

— *Transparency of Products*—The clear description of the price and benefits of the contract entered into should satisfy three objectives. At its simplest, it should enable the investor to understand the extent of benefits he is buying and their cost. Where complexity is present, it should inform the investor of what he could otherwise not reasonably know. Thirdly, it should enable the investor to make comparisons between competing products.

— *Honesty and Competence*—Investors are entitled to assume that the adviser and or firm with which they are dealing has demonstrated a track record of honesty. Regulation should also define and enforce minimum standards of competence. Competence must not be confused with knowledge. While adequate knowledge is an essential component of competence, it is the consistent application of that knowledge through skills which contributes most to investor protection and it is on this aspect that regulation should concentrate.

— *Provision for Redress*—In the event of fraud or malpractice, regulation must ensure that the legitimate claims of investors are met. In principle, this must always be from the resources of the offending firm, through a combination of adequate recourse to its own funds and, beyond that, through Professional Indemnity insurance. Funding of compensation via broadly based levies on other regulated firms must be the last, not the first, resort.

6. Regulatory Principles

The design and enforcement of regulatory standards must follow a set of clearly identified principles. Effective regulation should:

— Be based on clear regulatory objectives that avoid over prescription

— Achieve a proper balance between the rights and responsibilities of investors, intermediaries and product providers

— Provide for proper representation for regulated firms and consumers

— Safeguard the public interest

— Be accountable to the democratic process

— Encourage fair competition

— Confer benefits which are in proportion to its costs

— Ensure that enforcement acts as a deterrent to bad practice.

These statements are worthy of some expansion.

Prescription—Advocates of a prescriptive approach to regulation argue that it increases certainty. In practice, however, the proliferation of supra-legal rules which results from this approach leads to a focus on the letter, rather than the intention, of regulation by both regulator and regulated. Additionally, the level of complexity of the rules is leading towards a situation where the industry, especially the smallest companies, can have genuine problems in complying. What is needed is an end to governance by the rule book. In its place we should set a framework of legally enforceable principles, supported by regulatory objectives expressed as standards and actively enforced. This would provide the incentive for firms to adopt a "highest", rather than "lowest common denominator" approach in order to be certain of remaining within the law. The approach adopted by SIB in the New Settlement has much to offer the retail sector and should be developed. Supplemented by guidance, it can be applicable to even the smallest companies.

Balance of Responsibility—It is not the function of regulation to allow the abdication of responsibility by the consumer. While it must protect the consumer from being misled and provide him with the information to make an informed decision, it should not seek to eliminate his duty to decide his own priorities and act accordingly. Since 1988, regulatory obligations on the adviser, in the form of the "best advice" requirement, have developed to an extent where this duty has, for practical purposes, largely been transferred to the adviser. This does little to encourage responsible investors. Explicit product information at, or before, the point of sale should, if it fulfils its purpose, enable investors to make informed choices between suitable products. In turn, regulation should then concentrate on enforcing achievable standards of advice which ensure that advisers recommend only suitable products, rather than imposing a obligation which implies infallibility.

Representation—The provision for representation within any regulatory process should encourage informed debate at the vital formative stages of policy making, rather than relying on a formal process in which consultation tends to be late, limited and closed in nature. The structure of the regulator must allow for the continuity of practitioner involvement, and consequent build-up of expertise, which is vital for the formation of practical regulation. This must be accompanied by an open process of consultation, in which properly costed proposals are circulated for comment from all interested parties. The regulators' decisions should be published, along with the reasoning behind the decision, together with all the submissions received. Publishing the reasons for the decision is crucial to a successful consultation formula. It grants all those with an interest the right to be heard and the certainty their comments will be properly considered. It allows the Regulator the freedom to decide while ending the possibility of regulatory decisions being unduly influenced by any single interested party.

Additionally, consultation is an important component of the transparency and accountability which are essential features of fair and effective regulation.

Accountability—Every step by which regulation becomes further removed from direct scrutiny dilutes accountability to Parliament. The "two tier" theory of regulation may be viable in circumstances where the bottom tier is genuinely "self-regulation" and there is a genuine choice between this and the "statutory" tier. It is unnecessary, expensive and further dilutes accountability when, as is now the case, the bottom tier is "self-regulatory" in name only and is the only viable option for the majority of firms.

Inadequate accountability is exacerbated by the current powers conferred on SROs. The rules of an SRO, of which membership is voluntary in theory but mandatory in practice, are binding on its members and are wider than those conferred by legislation, yet subject to less scrutiny. In the absence of a structure of governance that guarantees appropriate practitioner and consumer involvement at this level, the practical effect is to place effective control of process, costs and initiatives in the hands of the Secretariat. However well intentioned this is not sufficiently accountable.

The Public Interest—The "public interest" has too often been interpreted in the regulatory context as being synonymous with "consumer interest". This is a distortion which fails to recognise that the two do not always coincide. It also promotes a simplistic and inaccurate view which implies that, left to itself, the industry will generally act against the interests of investors and the public. The public interest is concerned with securing the balance between the interests of investors, the industry and society as a whole that is necessary for the public good. As such, it is a responsibility of Government.

Representation of the public interest relies for its effectiveness on the personal and professional qualities of those appointed to fulfil the role, which must include:

— Proven ability to handle complex issues

— Appropriate breadth of experience at a high level

— An objective approach to the task

— Freedom from factional influence

— Recognised standing and seniority in society.

The nomination and selection of individuals with the required characteristics to serve on regulatory bodies requires, by its nature, objectivity and independence. It is a task which should be delegated, as for other public appointments, to an outside agency such as the Cabinet Office and not, as now, to the Board of the regulator itself.

The role of public interest Directors also needs clarification. In circumstances where the appointees are, almost by definition, not working full-time in the industry it is more realistic to expect public interest directors to exercise a supervisory function.

Competition—Any system of regulation should encourage fair competition between products that compete in the eyes of the consumer. The current system fails to do so in two ways.

In the first instance, the market determinator is inflexible and does not reflect the market. The rapid rate of innovation in the UK financial services industry has meant that insurance-linked investment and protection products and collective investment schemes compete at a cost disadvantage against increasingly complex deposit-based savings products. The former are subject to heavy regulatory costs and detailed product disclosure requirements, while the latter are subject to neither.

Products sold solely for protection which, as a consequence of their design, include a small element of "investment", are subject to the same disclosure regime as pure savings products, often with misleading results. In the field of pensions, regulated products compete with occupational schemes, in which the relationships between price and benefits are often even more complex and difficult for consumers to understand. Here the imbalance in disclosure requirements between the two reflects an historical perception of occupational schemes as a universal good; a view which is arguably no longer appropriate given predicted changes in patterns of work with more people changing job more often. Change is needed to enable consumers to make informed and unbiased choices between competing products, on the basis of information relevant to the product.

Secondly, within the scope of regulatory activity the proper costs of regulation will vary over time and across different distribution channels. It is the duty of the regulator to ensure that these costs are fairly allocated on the principle that each firm should be responsible for the costs of its own regulation. Cross-subsidies implicitly require firms to be financially responsible for the activities of other firms, over whom they have no control. Such arrangements are acceptable only as short term, transitional measures. Compulsory enforcement of such subsidies is anti-competitive and acts against the long term interests of investors by distorting the accountability of firms for their own behaviour. Cross subsidies in respect of fees and compensation are inherent in the current structure and operation of regulation. The OFT have objected to this anti-competitive practice, but have been over-ruled by Government. Cross subsidies between firms, or constituencies of firms, deny market forces and dilute accountability. In the longer term this misleads investors as to the true cost of their purchase and discourages investment in improved standards by those who are subsidised. They should be removed. It will be impractical and unfair to remove the current subsidies overnight; a transitional period of between three and five years should be laid down, over which the aim should be to reduce them to zero. This will enable smaller firms to adjust to fees and a fairer means of funding compensation to be found.

It is not necessary for the regulator to determine the method by which compensation is funded, only to determine the minimum level necessary to enable the market to function.

Alternative or complementary mechanisms for compensation include bonding arrangements, or a levy on sales of retail products, specific to each distribution channel. Such a levy would ensure that a proportion of compensation costs would remain predictable, enabling smaller firms to plan their finances more easily. It will not, however, solve the issue entirely.

Accountants and lawyers, who compete directly with IFAs in the marketplace, fund their own compensation schemes. They are required as a condition of practising by their professional bodies, to carry adequate levels of Professional Indemnity Insurance. Increasing the scope and required cover for firms is a possibility but the market should decide on the mechanism, not the regulator. It will involve greater professionalism across the intermediary sector but this will be to the advantage of the sector and consumer alike.

The availability of compensation and any ceiling on it should be disclosed to ensure the consumer is not misled. This will become particularly important when the EU Directive on Investor Compensation comes into effect, as firms based in other Member States will be subject to different, and currently lower, requirements when selling in the UK.

Costs—It is axiomatic that regulation should be achieved at a cost which is proportionate to the benefits it bestows. The cost of regulation should therefore be an issue only when it exceeds that necessary for acceptable levels of investor protection, or when unfair distribution of the burden distorts competition, either between companies competing in the same UK market, or with the EU and the rest of the world. The issue of regulated products competing with retail financial products excluded from the scope of retail regulation has been discussed above.

The costs of regulation, since the implementation of the FSA, have been great. While many of the changes have undoubtedly been necessary, they have been achieved in a manner which has been wasteful of resources within the industry and increases the cost of products to the investor. None of these changes have been the subject of published, detailed cost analyses—nor have the estimated costs been compared with the assumed benefits. At a more detailed level, SRO budgeting is unaccountable.

It is our firm view that it should be a statutory requirement that all significant proposals for regulatory change should be accompanied by detailed cost assessments.

Enforcement—The effectiveness of enforcement is at the heart of good regulation. Prescription diverts energy into the process of rule-making and focuses attention on the form, rather than the substance of transactions. Standards, expressed as objectives to be achieved, should be underpinned by fewer and more straightforward rules. Enforcement should then concentrate on the practical achievement of those standards through a programme of regular, frequent and in-depth visits. We would expect the great majority of the regulatory budget to be spent on enforcement.

The freedom to operate within a less prescriptive environment carries with it a responsibility to implement fully the standards set. An acceptable corollary to that freedom is the extension of the practical powers of the regulator in the event of serious breaches of responsibility.

7. THE SHAPE OF FUTURE RETAIL REGULATION

From the first discussions on the Gower recommendations, much of the debate focused on the issue of what constituted "self-regulation" and whether this was more or less desirable than "statutory regulation" in the interests of investors and the industry. In practice, even the definitions of these terms have never been universally agreed and the debate has generated more heat than light.

The term "self-regulation" implies a collective arrangement in which firms operating in the same market devise a voluntary scheme of rules governing their activities and police adherence to them. In contrast, statutory regulation means a system in which firms must comply with rules laid down by a statute itself, or made under enabling provisions in the statute.

In the context of financial services, the term "self-regulation" was widely used to describe the system endorsed by Gower and established under the FSA 1986, in which statutory powers to make rules were delegated by the Secretary of State to a Designated Agency, the Securities and Investments Board. The SIB was empowered to recognise "Self-Regulatory Organisations", or SROs, and Professional Bodies (RPBs) which were to provide a preferred alternative to direct regulation by SIB.

In fact this is not self-regulation at all, as both its structure and first tier of rules, with which the SROs were originally required to demonstrate equivalence, are established under statute. The self-regulatory element related only to the guarantee of practitioner involvement inherent in the governance of the SROs recognised under the statute. This guarantee was itself expressed in imprecise terms, requiring only that the governing body of SIB, or any SRO, was composed so as to:

— Include "persons with ... relevant experience of investment business of a (relevant) kind" and

— "Secure a proper balance between the interests of persons carrying on investment business and the interests of the public".

More recently, in the formation of PIA, much effort was dissipated in debating the level of this involvement, its allocation between different constituencies of practitioner and the consequent perceived "balance of power" which this produced within the new regulator.

The guarantee of senior practitioner involvement is essential to effective regulation. The ability of the regulatory system to respond appropriately to market and technological change depends upon providing for such input. While the decision on regulatory objectives and standards should be taken by a Board composed of public interest appointees, practitioners have a key role to play in working out what standards are necessary to attain the objectives. The enhanced consultation process described earlier would prevent regulatory capture by any one interested party.

It is unhelpful that the Act implies that the only balance to be achieved is between the interests of the industry and those of the public. As argued earlier, this confusion between "the public interest" and "the interests of the investing public" has been mirrored in the governance of the current regulators.

It will also be necessary to consider the relationship between the regulation of the marketing activities of providers and intermediaries and their prudential regulation. To date, the regulatory system introduced by the FSA has simply filled in the gaps in prudential regulation which existed before. As a result, the prudential regulation of providers has remained spread amongst departments of Government, statutory bodies, SIB and SROs. The providers, in turn, act as surrogate prudential regulators of their sales force, for whom they take fiscal and legal responsibility. The prudential regulation of intermediaries is conducted by the SRO or RPB to which they belong.

While it may be desirable in theory, there does not seem to be any compelling logic for bringing together the prudential regulation of all intermediaries, for whom prudential requirements are, in the main, simple and directly related to the scope of business undertaken. Any divergence of requirements between regulators for a given activity, such as portfolio management, will largely be eliminated by EU prudential requirements for intermediaries. However, providers such as Banks, Building Societies, Unit

Trust Managers and Insurance Companies increasingly offer overlapping ranges of products, while regulated separately for their prudential requirements. The regulatory system should ensure that differences in prudential regimes do not develop to an extent where they have a differential impact on companies competing in the same markets.

One practical solution would be the bringing together of prudential supervision for providers of all retail financial products and services under a single department of Government. This will greatly reduce the possibility of such differences developing.

It has been suggested that prudential and marketing supervision should also be combined under a single Government department or Agency. We do not find this argument convincing.

If prudential regulation of providers is to be brought together it would be appropriate to do so under the supervision of a department that is fiscally oriented, such as H. M. Treasury. There are circumstances where the priorities of the Treasury in managing the economy and those of a sponsoring department, such as the DTI, will be validly different. A division of responsibility would, in those circumstances, foster healthy debate which is unlikely to take place to the same extent, were it internal to a single department.

It is our view that the regulation of marketing activities should be overseen by a department whose primary functions include the promotion and competitive development of the market, of which marketing regulation is an essential component. We would argue that the responsibility sits well with other domestic responsibilities of general consumer protection, assistance to smaller companies and developing competition, which currently rest with the Department of Trade and Industry. In a wider context, there is also a close connection with the role of the DTI in promoting the interests of the industry in EU negotiations on the single market and in the General Agreement on Trade in Services.

We believe that similar disadvantages would apply to an all-embracing Financial Services Commission charged with both prudential and marketing regulation.

8. Alternative Structures

The preceding sections of this paper have covered a number of issues and principles relevant to the future of retail regulation. Successful implementation of these principles is, in some cases, a matter of changing process; in others it is linked to the structure and organisation of regulatory responsibilities, which will require legislative change. Changes to structure and process must, however, take place alongside the more fundamental change to regulatory culture, among both regulators and the industry.

The most important of the features that the new system must embody can be summarised as:

— Clear accountability, based on a single tier regulator

— A requirement to encourage competition

— A remit which covers all competing retail financial services products

— A culture based on direction by objectives, not prescription

— Fewer rules, enforced vigorously

— Deterrent penalties, commensurate with size and targeted at those responsible

— Open consultation, with timely practitioner involvement

— Compulsory compliance cost assessment.

Evidently these features can be accommodated under more than one structure. We have commented earlier that we do not favour a Statutory Commission for financial services that embraced both prudential and marketing regulation. Another option would be an Office of Investor Protection, along the lines of other sectorial market regulators. They are establishing their ability to promote competition and set standards, while combining this with comparative independence from Government and direct accountability to Parliament. Given the diversity and size of the retail financial services industry, statutory public interest and practitioner involvement, as described above, would be essential.

A more evolutionary solution would be to create the market regulator as an Agency of Government, under a suitably amended version of the Financial Services Act 1986. The Agency so formed would not duplicate any functions of SIB; on the contrary it would avoid duplication in the formation of regulatory policy and eliminate certain SIB functions and associated costs. In taking over responsibility for the supervision of the Recognised Professional Bodies, it would also be able directly to ensure the overall consistency of standards and their delivery which is essential to achieve the aims expressed earlier in this document. A structure for such an Agency, embodying the features described above, is outlined in

Appendix 1. It should be noted that both of these models would not be membership organisations. SIB would remain as the regulator for the wholesale financial services markets.

9. The Way Forward

We believe that the way forward should be based on the widest possible consensus and must achieve a sustainable settlement for regulation of the industry. We hope that the Chancellor of the Exchequer, jointly with the President of the Board of Trade, will agree to commission an independent review with two missions:

— To analyse and consider alternative options for the creation of a single tier regulator for the marketing of retail financial services, embodying the principles and practices expressed in this paper

— To examine the possibility of unitary prudential regulation for providers of retail financial services products

The timing should be so arranged that the recommendations, following consultation, can be implemented in legislation during the lifetime of the next Parliament. The precise terms of reference for the review should be determined following consultation with all interested parties.

Annex

SUGGESTED STRUCTURE OF GOVERANCE FOR A GOVERNMENT AGENCY

The Board—The Board of the Agency should report annually to Parliament and be scrutinised via the operations of the appropriate Select Committee, who would make recommendations to Government on its operations. It should have a supervisory Board, composed of public interest appointees and the Chief Executive. The Chairmen of the Executive Committee and the Consumer Panel (see below) should also attend in an ex-officio capacity. The Deputy Permanent Secretary at the DTI should sit on the Board, subject to suitable transitional arrangements with HMT, providing a direct link with the supervising Government department.

The Board should be charged with the duties of:

— Determining the constitution and operating standards (within boundaries laid down by the revised FSA)

— Exercising prudential supervision of the organisation and setting budgets

— Setting regulatory objectives policy guidelines and approving standards from the Executive Committee

— Publishing policy decisions, together with relevant submissions from the consultative process

— Receiving representations from the Consumer Panel on policy

— Accounting for the performance of the organisation to Government, Parliament and the public

— Receiving reports from the standing committees and the Ombudsman.

Decisions and guidance on standards should be passed back to the Executive Committee for implementation. The Board should approve an annual report on the activities of the Agency which should be published, together with the Operating Plan prepared by the Executive Committee.

Executive Committee—The Executive Committee should be composed of ten practitioners and the Chief Executive. Practitioner members should be appointed by the Board, from lists nominated by each of the regulated constituencies. Individual members should be at Board level in their companies and representation should be in proportion to market share.

The committee would elect a Chairman from among its members. It should be responsible for implementing the policy decisions of the Board, through a framework of regulatory objectives, operational standards and procedures covering:

— Training and Competence

— Selling practices

— Enforcement

— Reporting and Communications

— Budgets.

The committee should prepare, with the support of the Secretariat, an annual Operating Plan which should be published. Senior legal and policy staff from within the Secretariat should attend Executive Committee meetings in an advisory capacity.

The Secretariat—The Secretariat should report to the Chief Executive and have the following primary functions:

- — To provide administrative support to the Board, the Executive Committee and standing committees
- — To provide research and development, and analysis of options and proposals for the Board, Executive Committee and Standing Committees
- — To produce Compliance Cost/Benefit Assessments for all proposed standards ahead of the open consultative process
- — To conduct the consultative process with all interested parties and analyse the findings for the Executive Committee and Board
- — To conduct an enforcement programme and related administration functions.

It should have appropriate powers of recruitment and budgetary expenditure to fulfil these duties.

In effect, the Secretariat would be composed of two equally important divisions. One would be responsible for policy developments and one for enforcement. The Secretariat should be represented on all relevant standing committees and working groups. In addition to sitting on the Board and Executive Committees, the Chief Executive should also sit on the Consumer Panel.

The Consumer Panel—The panel should be an advisory body, consisting of ten individuals appointed from leading consumer bodies on the recommendation of the Cabinet Office. The Board should be required to consult the panel on policy issues and new standards. The Executive Committee and the panel should provide each other with minutes and agendas of their meetings. The Chairmen of the Consumer Panel and Executive Committee should also be invited to attend meetings of the other for items relating to the proposal of policy or strategy.

Standing Committees and Working Groups—The number and Terms of Reference of Standing Committees will vary over time, according to operational requirements. A permanent core of five committees is envisaged covering:

- — Authorisation
- — Audit and Financial Resources
- — Selling Practices and Market Developments
- — Training and Competence
- — Monitoring and Disciplinary Committee.

These committees should be responsible for a range of detailed monitoring, research and policy implementation functions, under the direction of the Executive Committee in the case of all but the Audit, Authorisation and Disciplinary committees, which would report directly to the Board. They should be composed of practitioners, in proportion to market share, and supported by appropriate officers from the Secretariat. Members of the Consumer Panel would attend by invitation of the relevant Chairman. The committees should provide annual reports on their activities to the Executive Committee.

5 July 1995

APPENDIX 9

Letter from the Chairman of the Board of Governors of the Federal Reserve System

I am writing in response to your letter of January 9. In your letter, you pointed to press reports of remarks by Governor Phillips, which indicated a concern at the Federal Reserve about the adequacy of existing controls over the derivatives market and the need for better disclosure. You asked whether I now share those views or whether I believe that the growth in derivatives markets was not yet a cause for concern.

I am not aware of any fundamental disagreements between my own views on derivatives and those of Governor Phillips. The growth of derivatives markets has, on balance, been a favourable development. However, that growth has been very rapid. While the technology of managing the associated risks has been greatly enhanced, we as central bankers cannot be complacent about the potential for problems. The appropriate response is not additional legislation to constrain these activities. Instead, central banks and other regulators should help to improve the legal and institutional infrastructure underlying these markets and should encourage the private sector to enhance further its risk management procedures. One important element in that process is improved reporting and public disclosure, which would enable market discipline to play an increasingly constructive role.

I believe that Governor Phillips would share these views. Indeed, they are quite consistent with a speech she gave at a conference sponsored at the Office of the Comptroller of the Currency on December 2, which may even have prompted the press reports. I am enclosing a copy of her speech. I am also enclosing a copy of testimony I gave in May 1994,[16] in which I presented the views of the Federal Reserve Board on the General Accounting Office's report on financial derivatives.

30 January 1995

APPENDIX 10

Memorandum submitted by Mr John Board, Mr Charles Goodhart, Mr Michael Power and Mr Dirk Schoenmaker, Financial Markets Group, London School of Economics and Political Science

1. Introduction and Summary

The study of the effects of derivatives can be divided into two major categories: the analysis of exchange-traded derivatives and the implications that over-the-counter (OTC) derivatives may have for the wider banking sector. One of the purposes of this note is to examine the implications of both of these for derivatives regulation, as well as the wider effects of derivatives on financial stability. This note will also draw lessons from the collapse of Barings.

When is Regulation Justified?

Economics suggest that regulation is justified only when manifest harm, or its potential, can be demonstrated. This harm is usually expressed in terms of externalities imposed on other participants or in terms of market failure.

Are Derivatives Markets Destabilising?

There has been a very large amount of academic research into the effects of derivatives markets. The overwhelming evidence (including that for the UK) is that derivatives markets are not destabilising, either in theory or in practice. In particular, the evidence is not consistent with the view that derivatives cause undue volatility in the underlying spot market.

Are Problems Those of Derivatives or Banking?

In terms of OTC derivatives, the major problems arise from problems of capital adequacy and internal control. We regard these as being general issues relating to banking, rather than being specifically related to banks' derivatives activities.

Summary of Issues

Positions in derivatives can change from minute to minute, so annual or even quarterly reporting is of little use for monitoring positions. One of the main challenges is to track derivatives positions for control and capital adequacy purposes. However, in practice, this can really only be done internally by each bank. Consequently there is a need for supervisors to move from rule-based regulation (e.g. detailed capital adequacy rules) to self-regulation (e.g. reliance on internal risk control systems). This raises the question of how the official regulators may best test and monitor internal risk control systems. Another challenge is to obtain useful information: for OTC markets on counterparties (credit risk) and total net positions (market risk); for exchanges on total positions (preferably consolidated at head quarters and known by home supervisors).

Summary of Recommendations

Our main recommendation is to improve and monitor internal risk control systems. The status of the internal auditor to check internal control procedures should be enhanced. In the aftermath of Barings, we expect both shareholders and management of banks to step up the monitoring of internal risk control systems. We do not believe that external or internal auditors should be brought into the regulatory process. But we see a need for reinforcing the role of the Bank of England's derivatives team for checking on internal risk control systems.

We recommend that derivatives activities of banks should be brought fully into the regulatory framework for banks, insofar as it has not already been done. In this context, international proposals (BIS, EU) to incorporate market risks in the capital adequacy framework are significant. We welcome

[16] Not printed but available in House of Commons Library and Records Office House of Lords.

the trend towards relying on banks' internal risk measurement models (which are more flexible and advanced) for capital purposes.

We reject calls for narrow banking. Prohibition of derivatives trading by banks may, in our view, destabilise the banking system rather than stabilise it. The focus should be on how to control banks' involvement in derivatives business rather than on forbidding it. We endorse initiatives to collect more data on the size and structure of OTC markets. Such information could greatly assist supervisors to analyse the systemic consequences of the collapse of one participant.

Margins are a useful device to reduce counterparty risk for exchange-traded derivatives. The clearing house is the appropriate party to assess the size of such margins, and no regulatory action is needed.

Because derivatives are useful, if only for hedging purposes, attempts to limit their use is likely to fail. Furthermore, regulation which is not introduced on an international level will just drive business elsewhere and ultimately off-shore.

2. Issues and Regulatory Responses

2.1 The Role of Derivatives

The main function of derivatives is to allow individual parties to transform risks arising from changing interest rates, foreign exchange rates, equity prices and commodity prices. Derivatives do not create new risks, but redistribute existing risks among participants. Derivatives increase economic efficiency in that they enable participants to unbundle risk components and trade them in a manner which they could not do, or not nearly as effectively, previously. It is widely accepted that derivatives are hedging vehicles which do not cause volatility but have developed in response to volatility (BIS, 1994b). Although risks can be reduced ('hedged') they can also be amplified by trading speculatively in futures, options and other derivative instruments. This is discussed below.

2.2 Differences between Exchange-traded and OTC Derivatives

Over-the-counter (OTC) derivatives are simply derivatives which are created as the result of bilateral negotiation between the parties to the trade, rather than through trade on a formal market. The benefit of OTC derivatives is that all terms of the contract (including, for example, the delivery date and contract volume) can be negotiated, whereas most terms of exchange-traded derivatives are pre-specified. The disadvantages of OTC products arise from the absence of a formal market place which leads to reduced liquidity and the absence of market oriented counterparty risk assessments.

The leading participants in the OTC market are banks, both commercial and investment. Risk reduction measures have arisen in the OTC market as part of prudent commercial activity. Such measures to reduce risk by financial institutions include: credit risk enhancement (e.g. third party guarantees, partial collateral requirements and early termination agreements) and daily marking-to-market (discussed below). In addition, derivative traders regularly use stress tests to simulate the impact of a large swing in certain foreign exchange or interest rates on their portfolio. Regulators may offer guidelines to encourage good practice.

In the case of exchange-traded derivatives, the clearing house is the central counterparty of all derivative deals. The solvency of the clearing house is crucial for the stability of the exchange. To protect itself against potential failures of traders, the clearing house typically requires traders to deposit an initial margin. Positions are daily (and sometimes even intraday) marked-to-market and variation margin calls are made when prices move. Most clearing houses have a loss sharing agreement among members and/or a reserve fund in case a member fails and its margins are not sufficient to cover its positions. For example, in the case of Barings the margins deposited at the Singapore and Osaka exchanges were sufficient to close Barings' outstanding contracts without a loss to the other members. Margin requirements are thus a very useful protective device against failure.

Should 'standard' OTC derivatives be brought to centralised exchanges?

This has been suggested as a method of reducing counterparty risk (Folkerts-Landau and Steinherr, 1994). Bringing 'standard' OTC products to exchanges is useful and some OTC-products have come to exchanges once standardised. A recent example is the introduction of so-called *flex* options. But we doubt whether this approach is feasible for the majority of OTC-products for the following reasons. First, specialised products cannot be traded on an exchange. Second, the demand for new specialised or customised products will continue. Finally, some participants may *prefer* the less transparent OTC market and would move business elsewhere if this was changed. Therefore, without prohibition of OTC-trading, exchanges and OTC-markets will continue to co-exist.

2.3 The Importance of Internal Control

There is a long term trend in all areas of regulation towards internal control and self-regulation so that internal and external audits have become important regulatory instruments. There are also economic pressures for the substitution of internal control for external supervision and oversight, possibly reflecting a fundamental trade-off between formal independence and expertise (i.e. that only insiders really know what is going on, especially in areas such as derivatives operations). Control techniques are well known: authorisation controls; segregation of access to assets and recording. But these controls can always be circumvented. For example, there was no segregation of trade and settlement in the case of Barings Futures in Singapore even though it not yet clear whether there was collusion in Singapore and/or between Singapore and London.

Although there may be a role for strengthening the culture of internal control, this requires internal auditors to be sufficiently strong to carry authority. At Barings, for example, internal auditors reported the lack of controls in the Singapore unit to the Board in London in August 1994. However, if, as at Barings, their recommendations carry no weight, so that no effective follow-up action is taken, internal audits are not useful.

It is tempting, if only because it is relatively cheap, to devise further roles for internal and external auditors post-Barings. Our view is that this would be a mistake. The main difficulty is that attempts to use internal audit functions for regulatory purposes would lead, in our view, to a deliberate reduction in the information contained in such reports. This would reduce their value both to the firm (which might use alternative channels to obtain the necessary information) and to the regulator. Ultimately, the internal audit would suffer from some of the problems associated with BS5750 (i.e. an auditing of form rather than substance) for the banking sector. Another example is the Cadbury code, which requires company directors to report on their internal controls. However, in practice, they provide minimal information by stating only that they have 'reviewed' internal controls without any statement on their effectiveness. This shows how much caution there is in this area in making any kind of 'certifying' statement.

Finally, it should be emphasised that those bank supervisors which do active on-site examinations (e.g. the Federal Reserve and the Office of the Comptroller of the Currency in the USA) pay regular visits as well as surprise visits to banks. The UK style of relying on external auditors involves only regular visits (which are expected and prepared by banks: fraud can more easily be hidden from pre-announced annual checks) and thus eliminates the surprise element. One alternative is that the Bank recruits its own investigators to pay surprise visits to banks to check controls. While the cost of stronger inspection is sizeable, the benefit is difficult to assess: how likely are examiners to detect fraud? The Bank has recently established a small specialist team for derivatives. This team should not only check on valuation models for capital adequacy purposes, but also on internal risk control models.

While it is easy to check whether the internal control procedures on paper are adequate, it is extremely difficult to assess whether procedures are applied. Moreover, the current structure of bonus payments makes the conscious adoption of a risky strategy the rational course for any trader, subject only to concern about his own future employment. Thus the internal control systems of a bank need to be tougher and more comprehensive, because they have to contend against an incentive structure which that same bank has put in place. Seen in this light Leeson was not just a unique 'rogue trader'. The bonus system tempts traders everywhere to emulate Leeson, but just to be luckier.

Another problem is how to control activities in foreign centres? The examples of Barings in Singapore and Standard Chartered in India show how difficult it is to control activities in foreign centres. As we said earlier, only insiders know what is going on.[17] The challenge is to put an appropriate incentive structure in place. Since shareholders have lost money, they (or rather their delegates, the non-executive directors) can be expected to demand adequate control systems and monitoring mechanisms.

3. OTC/Banking Issues

There are two particular issues which affect OTC derivatives. These are the possibility of systemic risk (i.e. the chance that problems at one bank will produce a widespread failure) and transparency (i.e. the fact that the risks of each trade must be evaluated by each party to the trade, in contrast to reliance on exchange clearance and the clearing house). It should be noted that although the former is economically very significant, it is really an issue in banking, rather than derivatives, regulation. This focus on bank regulation raises the question as to whether all derivatives players should be brought into the regulatory framework, or only deposit-taking banks. Apart from the systemic consequences, it is not clear that regulation of derivatives activity should bear harder on banks than on other institutions.

[17] In the BCCI case, an aggrieved former employee, Mr Rahman, acted as a whistle-blower. As a former chief officer, he had inside knowledge about some of the irregularities in BCCI. He talked first to the New York District Attorney and the New York Federal Reserve Bank, and later to the Bank of England (p.130-1, Bingham, 1992).

3.1 Problem—Systemic Risk

An important issue for banking supervision is whether derivatives contribute to systemic risk. Systemic issues arise when an incident at one financial institution (usually a bank) spreads to other financial institutions and/or financial markets.[18] The banking sector may be more susceptible to systemic problems than other financial intermediaries because they are interconnected (for example, through the payment system and the interbank market).

Moreover, a loss of confidence in certain banks or the banking sector as a whole may give rise to runs on banks not directly implicated in the original problem. This suggests that, although banking regulation and supervision should be designed to minimise the chance of any bank failing, rescues should be limited to cases of potential systemic break-down.

Another type of systemic crisis starts with a market wide plunge in certain asset prices, such as the stock market crash in October 1987. Without central bank intervention (providing liquidity to the system), such a systemic crisis may easily cause multiple direct failures and further indirect failures by institutions which are exposed to the originally failing institutions. The question is whether derivatives contribute to the likelihood of a systemic collapse of financial markets. Certain trading strategies such as dynamic hedging may (see below) contribute to volatility in these markets.

Apart from proposals to improve, and enforce, internal controls (see above), there have been several proposals for regulation which are discussed below.

3.2 Regulatory Response I—Capital Adequacy

Capital Adequacy rules are instructions issued by regulators to ensure that financial institutions have sufficient capital to cover their investment activities (which may differ in riskiness from bank to bank). The difficulty is to devise rules which incorporate the main risk categories and which do not permit manipulation designed to avoid capital requirements without reducing risk.

The major current international guidelines are the 'Basle Capital Adequacy Accord' and the 'EC Own Funds and Solvency Ratio Directives', adopted in 1988 and 1989 respectively. These are both designed to deal with credit risk which is the most important risk relating to bank loans. However, the main risks in a bank's trading activities (which includes derivatives and other short-term operations), are market risks such as foreign exchange, interest rate and equity price risk. The capital requirements for these types of risk are contained in the '1993 Basle Proposals' (not yet adopted) and the 'EC Capital Adequacy Directive' (adopted in 1993). These are critically assessed in IMF (1994).

The main advantage of the Basle approach is that, as it applies to all international banks, it creates a level playing field. Although there are some notable deficiencies (e.g. Japanese banks are permitted to include unrealised gains on equities in their capital base), a multilateral approach is required in today's global financial markets. A unilateral attempt by a single country to impose tough capital standards would simply drive business to less restrictive jurisdictions.

One of the main problems with these systems is the simplifications which must be made to design a useable method for calculating total risk, which is suitable for all market participants including smaller banks. Large banks with state of the art models to measure 'value at risk' might be allowed to use their own internal systems for risk measurement. The challenge for banking supervisors is then to test and monitor such models. This suggests that, rather than prescribing a certain format for risk measurement models or risk control systems, supervisors should encourage innovation by allowing such models and systems to develop and improve, while examining them against a benchmark of best practice.

Although capital rules are a valuable vehicle to internalise the riskiness of banks' activities, other forms of risk (e.g. liquidity or funding risk) are also important, but not yet addressed under these proposals. Any firm, industrial or financial, has to plan its cash inflows and outflows, and arrange for expected (and unexpected) cash shortfalls or liquidity gaps. The same is true for derivatives business. A derivatives trader should have sufficient liquid funds or borrowing capacity available to meet potential margin calls on its derivatives positions. The recent example of Metallgesellschaft highlights the importance of having adequate funding facilities in place (Edwards, 1994). Metallgesellschaft was using futures (and swaps) as a hedge against a large volume of fixed-price, forward supply contracts for oil. Because of falling energy prices, Metallgesellschaft had to fund sizeable cash outflows due to margin calls on its futures contracts. Even if Metallgesellschaft had equal and offsetting unrealised gains on its forward supply contracts, it would still have had to borrow to meet these cash outflows because of the illiquid nature of its forward contracts.

[18] There have been suggestions that the role of Barings as clearer for other agents in financial markets, which did not have adequate procedures for shifting that function in the case of a failure, almost led to some systemic externalities.

3.3 Regulatory Response II—Narrow Banking and Ring-Fencing

There have been several calls for narrow banking in the wake of the Barings crisis (FT, 27 Feb 1995; The Economist, 4 March 1995). In its purest form, narrow banking means that deposit-taking banks are only allowed to invest in highly liquid, safe assets such as government securities (Litan, 1987). Government guaranteed deposit insurance is then exclusively available for these narrow banks, although there will be (almost) no need for such deposit insurance as these narrow banks are relatively safe. Lending (as well as other risky activities) has then to be channelled through financial institutions which fund themselves with uninsured liabilities such as commercial paper.

A more moderate form of narrow banking is that relatively risky activities have to be conducted through a separate subsidiary. The risky part is then 'ring-fenced' and the insured part of the bank is not allowed to channel funds to the uninsured subsidiaries unless prior approval from the bank supervisor is obtained. This structure ensures that the deposit-taking part of the bank will not be contaminated by the risky parts of the bank. Apart from the question whether such narrow banking proposals are feasible (essentially whether banking supervision and the public safety-net could really be confined to these narrow banks)[19], it is not clear whether such narrow banking schemes are desirable.

A market based version of this approach is the recent trend (noted in Dale, 1995) for major US securities firms to establish derivative product companies, *DPCs*, arguably to escape the SEC's regulatory oversight (including capital adequacy rules).[20] This arrangement allows banks' derivatives trading to be assessed by credit rating agencies, which act as surrogate but market based regulators of the *DPCs*, and which will base their rating (*AAA* for most banks which have made this change) on assessments of capital adequacy, maximum counterparty risk, transfer of market risk etc. Whether this should be viewed as an interesting development or a potential regulatory problem is unclear.

Dis-intermediation has resulted in a decline in the charter value of banks over the last two decades, but banks have found new ways to make profits in securities (e.g. by underwriting) and derivatives activities. This means that derivatives activities have moved closer to the core of banks' activities and means that there may be severe operational difficulties in attempting to separate derivatives from banking activities. For example, should only proprietary trading be ring-fenced or should OTC derivative trading with clients (i.e. acting as counterparty to a client who wants a particular derivative) also be separated? A similar type of market risk is involved in each case and the level of risk is dependent on the degree of hedging, not the motivation for the position. Furthermore, preventing a bank from entering the derivatives market altogether will prevent it from hedging its own potentially risky mis-matches. The result could be worse, as the banking system might be less stable without the opportunity to hedge. Allowing banks to use derivatives for hedging, but not for speculating purposes raises the thorny issue of dividing derivatives activities into hedging and speculating. We would argue that such a distinction cannot be effectively assessed by outsiders. Finally, forbidding deposit-taking banks from engaging in derivatives trading on their own account (i.e. by banning proprietary trading) would make banks less profitable and might even encourage them to take on more risk in their traditional business. This might, therefore, make the banking system less stable in the long run.

The calls for ring-fencing or narrow banking in the wake of the Barings collapse is comparable with the response to the US banking crisis in 1930s. The Glass-Steagall Act was introduced to separate commercial (loan business) and investment (securities business) banking. Stock holdings by banks were thought to be one of the main causes of the multiple bank failures during the Great Depression and were subsequently forbidden[21]. Recent research (e.g. Benston, 1990), indicates that this view was premature and without much foundation. But reversing the Glass-Steagall legislation has so far proved to be very difficult. We believe that the focus should be on how to control banks' involvement in derivatives business rather than on ring-fencing or forbidding it.

3.4 Problem—Counter-Party Risk and Transparency

It is important that parties can assess counterparty risk. Over-the-counter (OTC) traded derivatives are not transparent, in that the information required to assess correctly a bank's derivatives exposure is mostly lacking. We separate the transparency issue into two parts: at the *participant* level, the focus is on the information required by potential counterparties to a trade, while, at the *supervisory* level, the focus is on the information required by regulators to assess the overall structure of markets. Increased transparency is also very useful in times of a crisis as it enables the authorities, as well as individual agents, to evaluate the impact of the crisis on the different market players. Without information to

[19] Is it really possible for the authorities to confine the public safety-net to the insured narrow banks? What happens, for example, if one or more of the uninsured financial institutions get(s) into trouble? Are these uninsured 'banks' able to cause a systemic crisis and may the central bank as lender of last resort then wish to intervene to prevent a systemic break-down of the financial system?

[20] It is not clear under existing UK regulations whether *DPCs* would still be regarded as banks and therefore remain subject to banking supervision.

[21] Another reason for separating banking and securities activities was to avoid conflicts of interest between debt and equity holders.

differentiate between affected and non-affected financial institutions, rumours can adversely affect healthy institutions.

3.5 Regulatory Response—Mandatory Information Provision

Participant Level

At this level the participants to any OTC derivatives deal need the information to assess each other's risk. It can be argued that derivatives and other off-balance instruments have reduced the transparency and information content of balance sheets; however, while this may be true, it is unlikely to affect the decisions of OTC participants, who can demand detailed information of each other.

Nevertheless, some general information will be required, if only to facilitate comparison between institutions. This suggests that a minimum degree of standardisation of accounting for derivatives may be required. The Fisher Report (BIS, 1994a) argues that differences in the information about risk and risk management available to managers and to outsiders may lead to a mis-allocation of capital among firms. To improve transparency, the Fisher Report proposes that information generated by internal risk management systems should be adapted for public disclosure purposes. Such information would complement, but not substitute for, disclosures based on traditional accounting. The Report recommends that all financial institutions (regulated and unregulated) should move into the direction of publicly disclosing periodic quantitative information on the market risks in the relevant portfolio, the actual performance in managing these risks over the reporting period, and counterparty credit risks arising from its trading activities.

The Report suggests, as an example of market risk reporting the presentation of 'value at risk' (for a given confidence interval and period) at the reporting date, and as an example of the actual performance of managing market risk reporting the presentation of the average daily value at risk, or a diagram of daily changes in portfolio value over the reporting period. The example of credit risk reporting includes: current credit exposure, broken down by credit quality class. A more profound change would be the adoption of 'scenario reporting' in which banks report the value of their derivatives positions under a variety of different scenarios (rather than emphasising a single figure as required under present accounting rules). While the definition of these scenarios could be left to individual firms, an alternative would be to standardise by adopting the methods used by derivatives clearing houses (e.g. SPAN) or the recently published RiskMetrics (originated by J.P. Morgan).

Another response is to require that all OTC trades are marked to market on a regular and frequent basis (daily or weekly). At a minimum, this would involve regular, formal, valuation of open positions and the possible exchange of cash when this value changes. Since many OTC positions are already informally marked to market, a requirement to do so might not be excessively onerous, though one reason often given for the popularity of OTC trades is that it leaves marking-to-market to the discretionary decisions of the parties involved.[22]

Although there is scope for improvement in disclosure, there are limits to what can be achieved. Even with mark-to-market accounting and frequent reporting (e.g. each quarter), information can still be outdated. As credit rating agencies are gathering information on a continuous basis, credit ratings of institutions may be a useful tool in the assessment of counterparty risk.

Supervisory Level

The Brockmeijer Report (BIS, 1995) identifies a need for better statistical data to assess the implications of derivative markets for the policy responsibilities of various public authorities. An internationally co-ordinated approach (by central banks) to collecting these data would aim to shed light primarily on the size and structure of the global OTC derivatives markets. The existing data on derivatives markets, whether gathered by central banks or by market associations, have a number of important shortcomings (e.g. differences among various reporting systems in terms of range of instruments and institutions covered; existing data focus on notional amounts of contracts and are uninformative as to size and risk incurred; existing data provide only limited information on the structure of participation).

The Report recommends two complementary approaches for the collection of data needed for compilation of global market size characteristics: (1) occasional surveys of a large number of participants to obtain broad scans of derivatives market activity; (2) a system of regular market reporting confined to the main intermediaries in the derivatives markets. Both the survey and regular market reporting would collect data on the notional and market values of outstanding contracts, disaggregated by broad underlying market risk classes (i.e. exchange rates, interest rates, equity prices and commodity prices) and by instrument type, counterparty type, maturity and currency. To shed light on linkages between OTC and

[22] Conceptually, an OTC product negotiated between a bank and its client can be seen as a pure derivative and a credit line. As mentioned in section 2.2, banks actively manage the credit risk inherent in OTC derivatives. If banks would like to reduce their credit exposure to certain clients, they could, for example, ask for a letter of credit or collateral (see also Group of Thirty, 1993).

exchange-traded markets, it also recommends collecting data on the exchange-traded activities of the reporting institutions. It is not clear how large the resulting reporting burdens will be.

Initiatives to gather industry-wide information such as the Brockmeijer Report (BIS, 1995) are informative and helpful, especially to reduce systemic risk. Only with regular information on the major players and on the derivatives markets (both OTC and exchanges), can supervisors and individual agents alike better assess the situation during times of stress. It will be easier to neutralise rumour driven panics. Moreover, supervisors will be in a better position to analyse the impact of the collapse of one participant on other participants and on the stability of the wider financial system.

4. Exchange-traded Derivatives

4.1 Do Derivatives Increase Risk?

Derivatives are often criticised on the argument that they increase risks, particularly of the underlying market. We consider some different aspects of this question below.

Volatility

A large amount of evidence (e.g. Board, Goodhart and Sutcliffe, 1991, 1992) suggests that exchange-traded derivatives do not induce additional volatility in the spot market. This means that the measured volatility of the underlying market does not increase either with the opening of derivatives markets or with growth in the volume of trade on those markets.

It is important to recognise that volatility is not in itself undesirable. Volatility is caused by trade and the arrival of new information leads to trade in an efficient market. What is undesirable is excessive volatility which is unrelated to informed trade. There is considerable evidence that transactions costs (i.e. bid/ask spreads and commissions) are much lower in derivatives markets than in the underlying equity market. One implication of this is that traders with information might prefer to trade in derivatives markets. This suggests that 'price discovery' is facilitated by the existence of derivatives, and academic evidence consistently suggests that futures markets *lead* the corresponding underlying market by about 5 minutes. This suggests that derivatives enhance market efficiency.

It is also interesting that both the Bank of England and Stock Exchange reports on the crash of 1987 highlight the *low* level of derivatives and arbitrage activity as reasons why recovery from the crash was slow. There is no evidence from either the US or UK that derivatives caused, or contributed substantially to, the crash.

Speculation

It is often asserted that excessive volatility is caused by the speculative nature of derivatives markets. This behaviour will, it is alleged, induce large price swings in both derivatives and spot markets. However, if the spot market is 'correctly' priced, it would be sensible (and profitable) for spot market participants to take riskless positions against speculators (e.g. if futures prices are driven too high by speculators, selling futures backed by equity, will be very profitable). This would eliminate any excess volatility. It is of interest that there are reports that some large investors were taking positions against Leeson (i.e. selling him the futures contracts which he was buying).

A second issue arises when it is alleged that negative market sentiment is expressed through, levered, derivatives positions. While this is possible, negative sentiment could be expressed equally well by selling the underlying asset using borrowed funds (or broker's credit). Therefore, it is unclear why derivatives should encourage such speculative behaviour.

Liquidity

Another question is whether derivatives activity reduces spot liquidity. The suggestion is that, as derivatives markets typically have much lower transactions costs than the spot market, it is possible that derivatives markets will begin to dominate the spot. This might lead to a drift of capital away from the spot market, leading to a loss of liquidity and a fall in efficiency. This is an open question, but no sign of this effect has been reported in the UK or Japan/US (where in these latter countries nominal equity derivatives activity is several times that of the underlying equity levels). Equally, equity market inefficiency would be exploitable by traders, and their (arbitrage) actions would tend to eliminate any price disparity between markets.

Knowledge

A contentious issue is whether there is a need for suitability criteria for users of derivatives. In the aftermath of the Gibson Greetings and Procter & Gamble cases, there have been calls for such criteria. Mis-representation appeared to be an important element in the Gibson and Procter cases. Access to civil law provides an adequate remedy against these cases of misrepresentation. Moreover, a suitability criterium is already part of the core conduct of business rules published by the SIB and SROs (rule 16, SIB, 1991). This principle of 'know your customer' is applicable to derivatives as well, so there is no automatic requirement for new regulation here. Clearly, however, derivatives are more complex than other investment vehicles and reinforcement, particularly for private business, of these rules may be beneficial.

4.2 Inter Market Linkages

The existence of derivatives markets may also have implications for the operation of the market in the underlying asset. One example of this is the current concern with the transparency (i.e. the fact that publication of the details of almost 50 per cent of the value of Stock Exchange transactions is delayed for 90 minutes). There are arguments that this structure imposes costs on the system as a whole (e.g. Board and Sutcliffe, 1995). It is also claimed that derivatives growth is hindered by lack of spot market transparency. This is unproved, but it cannot be desirable for the current spot price to be unobserved when trading derivatives. At a minimum, this creates asymmetrics of information which may lead to volatility or a withdrawal from the market (this latter effect is alleged by LIFFE). Whether this is the case or not, LIFFE's equity options (in contrast to most of their other products) are measurably less successful than those in other competing markets.

A second issue is whether programme (i.e. automated) trading strategies can cause problems in the cash market. These strategies need not involve the explicit use of derivatives. The major problem is that an institution which, say, wants to sell a large volume of stock may be doing so because it has negative information about the stock or because it has decided to rebalance its portfolio (i.e. a programme trade). The former will lead, correctly, to a large price fall; the problem arises if the latter were mistakenly to be interpreted as being information related. 'Sunshine trading' has been suggested as a method of avoiding this problem. Essentially, firms pre-announce their intention to buy or sell as part of a programme trade. In the US, this practice was ruled to be in conflict with pre-arranged markets rules in the US. In the UK, the system of 'one day protection' can be argued to achieve the same effect. There is also evidence that information about the parties involved in block trades filters into the market informally.

4.3 Margins and the Clearing House

There are two separate roles for margins and the distinction between them is important. First, margins act as an initial deposit to minimise the risk of default to the clearing house (which acts as the counterparty to all deals on the exchange). To protect itself against potential failures of traders, the clearing house typically requires traders to deposit an initial margin and further variation margin calls are made as prices change. The size of these margin payments seems most appropriately assessed by the clearing house itself (presumably in consultation with its members), and is likely to be based on the average daily price movement and the probability of default. In these terms, there is no particular evidence that margins are generally too low (note that, for example, Barings' positions were closed within 36 hours with minimal price impact and no calls for additional funds by clearing houses in either Singapore or Osaka). This use of margins for the avoidance of default risk is the principal purpose of margins on derivatives markets.

Second, margins can be used to control the leverage of individual positions (e.g. a multiplier). This is often used as the basis of arguments that control over margins would stabilise the market. However, there is no evidence from the US (e.g. Hsieh and Miller, 1990) that margins act as an effective control over volatility. It should also be emphasised that raising margins reduces liquidity and reduces the attractiveness of markets. This may drive business overseas or onto OTC markets.

It is important to realise that any system which advances credit is susceptible to Barings type problems. For example, on the London Stock Exchange, even rolling *T+10* settlement gives 10 days to run up levered speculative positions. Note also that brokers often allow clients significant private credit which may be of longer duration than the exchange's settlement period (c.f. in a different context, the Stock Exchange's current concern with short selling of new equity issues).

There are occasional proposals to reinforce the requirement of marking-to-market of OTC derivatives by the establishment of a clearing house. This proposal deserves some consideration, but because of the concentrated nature of much OTC business and the difficulty of credit screening for the remaining customers, this idea is unlikely to be practicable. Were it a viable and efficient possibility, banks might be expected to create such a mechanism themselves, without regulatory intervention.

5. The Barings Crisis

5.1 How Did It Happen?

In the absence of full information about Leeson's trading positions and the order in which they were undertaken, we will not speculate on his strategy. However, it is known that he was authorised to take large hedged positions so as to exploit small pricing differences between Nikkei index futures traded on the Singapore and Osaka futures exchanges. The problem apparently arose because the trader actually took large unhedged positions. Although exact data are not yet available, newspaper reports suggest that the nominal value of these positions exceeded $7bn, which was far beyond the authorised limits. It is important to recognise that derivatives positions of this size are not unusual (a number of UK banks have greater exposure than this), but that the problems arose because of the size of the open positions relative to the bank's capital.

It is clear that internal risk control procedures should have revealed the unusual position. If positions are hedged, then contracts/positions running into deficit should be offset by contracts showing a surplus. While the negative positions have to be covered via margin calls in exchange-traded contracts, surpluses should arise at the other contracts and the net margin payment at any time should be close to zero. A simple check whether Barings Futures Singapore had unrealised surpluses on the other contracts would have indicated that these supposedly offsetting contracts were not in place and hence positions were unhedged. It is unclear why this, and other, obvious warnings were ignored when senior management in London permitted continued trading and actually authorised the transfer of liquid funds from London to Singapore to meet the required margin calls.

It should be noted that Barings' large positions on the Singapore and Osaka exchanges were based on simple exchange-traded derivative instruments and were publicly known. There is no question, therefore, that the lack of transparency attributed to OTC derivatives could have been involved. Overall, it seems that the Barings collapse is principally a case of the breaching of internal guidelines together with the failure of internal control systems rather than being attributable to the misuse of complex derivatives.

Although both futures markets involved will have been aware of the large positions adopted by Barings, neither could have observed directly the size of the bank's net, unhedged position. To do this would have required data from all other markets in which the bank could have been trading (to hedge or to lever further the position on its own market) and not just from one market. Consequently it is difficult for any one market to observe and to warn (either the firm or the supervisor) about the effect of large positions between markets or on the interactions of such positions. The issue of the extent to which competing exchanges will voluntarily exchange information is an open one.

One question which deserves some consideration is whether an international official body should be established, when several derivative markets are trading the same contract, to receive and collate data from both. An argument against this is that a trader wishing to disguise fraudulent trades could move part of his deals to the OTC market. Nevertheless this does raise one of the key questions which is whether the information available on a systematic basis to regulators, internal or external, is sufficient, and, if not, how it can be enhanced.

5.2 Was Closure the Right Decision?

Bailing out by the central bank is justified only if there is a demonstrable systemic consequence to failure. The initial assessment in the weekend of 25/26 February, that there was limited, systemic risk arising from the Barings collapse, proved to be correct. This was a case of failure caused by unauthorised large open positions resulting from proprietary trading, and a failure of internal control systems. Following the collapse of Barings, every banker in the world will have reassessed whether their own bank's internal risk control system would have prevented that happening to them. Had Barings been bailed out, that signal would have been muted and distorted. Thus, market discipline is likely to have been reinforced by the decision not to rescue Barings.

The attempt by the Bank of England to organise a lifeboat for Barings was, however, justified, as long as it was to be financed by the banking sector itself. But the use of taxpayers' money (either indirectly via the Bank's accounts or directly by the HM Treasury) is not justified under such circumstances. It would have sent the wrong signal to the market.

It is reported that the lifeboat failed because the participating banks wanted to cap the overall size of the support action. This was impossible as Barings had still outstanding derivative contracts which might have moved further downwards. It has always been difficult to assess the size of liquidity/solvency problems when a bank fails. This contrasts with 'traditional' failures in which the major task is to assess the real value of bad loans. Although this value will be lower than the nominal loan value, the potential loss is bounded (i.e. it cannot exceed the face value of the bad loan). However, with large open positions in derivatives and the market knowing that you have to close-out or unwind these positions, the potential losses are potentially unlimited. As normal statistical relationships tend to break down during crisis situations, the potential downward risk is difficult to calculate: how many hours/days will it take before the position can be unwound and what will be the price movement over this period?

Although there were only limited systemic risks arising from the failure, there were a couple of consequential effects which had not been fully anticipated. First, it had been thought that funds under management by a bank acting in separate capacity as fund manager were entirely 'ring-fenced'. Now we learn that the cash in such funds are quasi-automatically deposited 100 per cent with the parent, protected in the case of the parent's failure only by the deposit insurances up to 75 per cent of the £20,000 limit. That must now stop. Fund managers should be given the duty to undertake prudent diversification of cash holdings in their funds.

Second, Barings had been acting as clearing agent for certain other financial intermediaries in some markets. When it failed alternative mechanisms for switching the clearing arrangements were not in place in some cases, leaving those intermediaries who had used Baring in this capacity in an exposed position. The participants in the markets involved, and those markets, need to review their own procedures on this. But, while the official regulators have an interest, the initiative on this should come from the private sector participants.

5.3 Lessons from Barings

The main lesson it that effective and stringent internal risk control systems have to be in place and enforced. In this case there was no separation of functions: trade (front office) and settlement (back office). A related issue is that internal audit reports should be taken seriously. The second lesson is that, in the context of several competing markets, and OTC trading, information on (net) positions is hard to assemble to get a complete picture, even for the bank itself (when its own internal control and reporting systems are breaking down), and more so for the individual markets and official regulators. It is not yet at all clear exactly who, at Barings, Singapore, Osaka or the Bank of England, knew what and when.

The main responsibility must fall on internal control mechanisms. If the bank itself does not know what is going on, how can the official regulators be expected to do so? One feature of the derivatives market is the speed and extent to which speculative positions can be assumed, or unwound. If a trader can destroy his own bank within a few trading days by taking huge unauthorised positions, is it either feasible or desirable for the official regulators (as contrasted with the bank itself) to be continuously looking over the shoulder of all such market activities? Indeed, any need to do so will have been lessened by the salutary experience of Barings failure.

But, if such large weight is to be placed on bank's own internal control mechanisms, then it behooves official regulators to be confident that these are satisfactory and in good working order. This does raise the question of international co-ordination, since control failures are, perhaps, more likely in smaller subsidiaries, or branches, abroad rather than at head office. There have been some, rather general, calls for international regulatory co-ordination in the aftermath of Barings. It has not been clear to us exactly what aspects of regulation are supposed to be co-ordinated by the authors of such calls. But one such important area relates to the satisfactory application of internal control procedures at overseas branches/subsidiaries. One should leave assessment of the adequacy of internal control procedures, and their application in the home country, to the lead regulator, but should assessment of their satisfactory application in host countries be the responsibility of the home or host country? Some clear ruling is desirable.

As will have been seen, we regard the Barings case as primarily the result of a failure of internal controls, rather than the 'fault' of the derivatives markets *per se*. Indeed such positions could just as easily have been taken on other (spot) markets, although somewhat arguably less rapidly and on a less devastating scale.

6. Recommendations and Conclusions

There is no evidence (in theory or practice) that derivatives destabilise the financial system. Derivatives trading is beneficial in that it allows agents to unbundle risk components and trade them in a cost-efficient way.

As derivatives traders can change their positions intraday, it is difficult for outsiders to keep abreast of traders' positions. Our main recommendation therefore is to improve and monitor internal risk control systems. Traders should set internal limits and ensure adequate mechanisms to control these limits on a regular (at least daily) basis. The role of the internal auditor to monitor internal control procedures should be strengthened. In the aftermath of Barings, we expect both shareholders and management of banks to step up the monitoring of internal risk control systems.

We do not believe that external or internal auditors should be brought into the regulatory process. Requirements for internal auditors to report their findings to banking supervisors, for example, may lead to an auditing of form rather than substance. But we see a need for reinforcing the role of the Bank of England's derivatives team for checking on internal risk control systems.

The banking system is suspect to systemic risk. Derivatives, as well as other banking activities, may cause a systemic failure. We recommend therefore that derivatives activities of banks should be brought fully into the regulatory framework for banks, insofar as it has not already been done. Regulators have been working on an international basis (BIS, EU) to formulate minimum capital adequacy rules for market risks. We welcome the trend towards relying on banks' internal risk measurement models for capital purposes, as such models are more flexible and advanced. Risk reduction measures (e.g. third party guarantees, partly collateral requirements) have arisen in the OTC market as part of prudent commercial activity. Regulators may offer guidelines to encourage good practice.

We reject calls for narrow banking. Prohibition of derivatives trading by banks may, in our view, destabilise the banking system rather than stabilise it. The focus should be on how to control banks' involvement in derivatives business rather than on forbidding it. We endorse initiatives to collect more data on the size and structure of OTC markets. Such information could greatly assist supervisors to analyse the systemic consequences of the collapse of one participant.

Clearing houses rely on margins to reduce counterparty risk of derivatives traded on exchanges. The clearing house is the appropriate party to assess the size of these margin positions. There is no particular evidence that margins are generally too low. Although we see some merit in initiatives to bring 'standard' OTC products to exchanges, we do not believe that intervention by regulators to 'force' OTC traders to shift (part of) their business to exchanges would be warranted or successful.

Because derivatives are useful, if only for hedging purposes, attempts to limit their use is likely to fail. Finance theory reveals how portfolios with characteristics equivalent to derivatives (including their leverage) can be constructed from traditional securities, attempts to ban or to restrict explicit derivatives (or their markets) will simply lead to increased use of less heavily regulated markets. Furthermore, regulation which is not introduced on an international level (e.g. Basle) will just drive business elsewhere and ultimately off-shore.

22 March 1995

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APPENDIX 11

Memorandum submitted by Professor Richard Dale, Specialist Adviser to the Committee

BARINGS: THE REGULATORY IMPLICATIONS

The full facts surrounding the Barings collapse have yet to be established, but whatever the outcome of the various enquiries now in progress a number of questions concerning present international financial regulatory arrangements will have to be addressed in the wake of this affair. These questions can be considered under four broad headings: regulatory co-ordination, enforcement, separation of activities and the lender of last resort (LLR).

Regulatory Co-ordination

Regulatory co-ordination has to be considered from a geographic and functional point of view. So far as the geographic dimension is concerned, serious problems have been highlighted by the Barings collapse. In this context it should be borne in mind that the Bank of England regulated Baring's London securities and banking units on a fully consolidated basis, meaning that the assets and liabilities of the two sides of the business were aggregated for regulatory purposes. Barings' overseas banking branches were also included in this consolidation. The Securities and Futures Authority (SFA), on the other hand, regulated Barings Securities as a separate entity but did not oversee its foreign subsidiaries, such as Baring Futures (Singapore), which were subject to local regulation by the host authority (see Chart).

The troublesome feature of these regulatory arrangements is that the supervisors of Barings' foreign securities subsidiaries did not report either to the Bank of England as consolidated regulator or to the SFA as securities regulator. Nor did the foreign securities regulators (e.g. Singapore and Osaka) talk to each other. Furthermore the SFA did not provide information to the foreign regulatory authorities (e.g. that Mr Leeson's application for a trading licence had been referred back). Each regulatory jurisdiction was behaving as if securities markets were neatly segmented along the same lines as their own regulatory responsibilities—whereas in reality these markets know no boundaries. The clear lesson is that securities regulators need to address very rapidly the question of global supervisory co-operation in much the same way that the Basle banking regulators have established clear guidelines for co-operation between their jurisdictions (see below).

Regulatory co-ordination also needs to be considered from a functional point of view. Here the question is whether banking and securities regulators adequately co-ordinate their activities—or whether an overarching regulatory authority covering both businesses is needed. It seems that Simex, as a securities regulator, was (understandably) concerned mainly to protect its counterparty risk by ensuring that margin requirements were met: the possibility that Barings Securities' own-account trading could threaten the affiliated bank was not a primary preoccupation. These priorities underline the different approaches of banking and securities regulators.

In London, responsibilities for Barings' operations were split between the Bank of England and the SFA. At this point it is not obvious that the dual agency regime gave rise to serious problems, although it may turn out that Barings was more easily able to evade the Bank's large exposure limits (see below) by channelling margin payments to Singapore and Osaka (single counterparty exposures) through its securities subsidiaries. In this way 'client' funds and own account funds could become confused and it would be difficult to establish whose exposure the margin payments represented. The absence of consolidated supervision of Barings' securities operations may have compounded this difficulty. What cannot be denied is that the division of responsibilities between securities and banking regulators worldwide greatly complicates the matrix of regulatory responsibilities that cover the operations of multinational and multi-functional groups such as Barings and thereby increases the scope for regulatory evasion.

Enforcement

On the evidence to date it seems that Barings may have been in breach of Bank of England rules (notably the 25 per cent prior authorisation requirement for large exposures) as well as commonsense prudential standards (e.g. the separation of trading and back office responsibilities in Singapore) and detailed Bank of England guidelines in internal controls. The possibility that even blue-chip institutions may behave in this reckless way presents formidable problems for supervisors. Essentially, they can rely on one or other (or some combination) of the following techniques for enforcing minimum prudential standards and rules:

(a) Reporting to the supervisor. In the Barings case, reports to the Bank of England did not reveal the massive build-up of market positions and large exposures, partly because of the speed of the build-up, partly because the main statistical reports are made only quarterly (end March data would have provided the first opportunity to identify major problems) and perhaps also because the data would have been unreliable given the false trail being laid in Singapore.

(b) Reliance on external auditors. Under present UK arrangements external auditors have an important enforcement role. This is based on the annual reports they must provide on banks' internal controls, their new statutory obligation to report certain matters directly to the Bank of England and the special investigations they undertake on behalf of the Bank. It is not clear at this point what, if any, flaws in the auditing regime were present in the Barings collapse.

(c) Bank examinations. In the US and some other jurisdictions enforcement is based on a specialist bank inspectorate employed by the supervisory agency. This approach is costly and it is not obvious that bank examiners are in a better position than external auditors to identify fraud or breaches of prudential rules and guidelines (although US regulators argue that this is so).

(d) Penalties. Effective enforcement depends in part on directors and senior management understanding that they will suffer heavy penalties should they breach Bank of England regulations or engage in unsafe banking practices. If, as seems likely, serious shortcomings of this kind are found within Barings' top management it is important that appropriate disciplinary action is taken. Public hangings may be a necessary deterrent in a world where the risk/reward calculus facing senior executives in the securities business is becoming increasingly asymmetrical.

Separation of Activities

Various 'separation' issues have been raised by the Barings collapse. Clearly it has underlined the folly of not separating the trading function from the back office; it may also point to the need to separate more clearly own-account trading from client business (in this particular case Barings was technically a 'client' of the futures operation in Singapore); and it has important implications for the treatment of client money. On this last question there are three potential areas of confusion: the depositing of asset management cash with a related bank (there are no rules against this in the UK) may jeopardise the security of investors' funds; the routing of client margin payments to foreign jurisdictions (e.g. Tokyo) which lack clear client money segregation rules may unexpectedly expose investment clients to default risk; and the status of margin payments may be unclear where both own-account and client business has been undertaken and margin requirements are assessed on a net rather than gross basis.

However, by far the most important separation issue concerns intra-group funding of high-risk trading and securities activities. There is a strong case for establishing 'funding firewalls' to prevent banks from lending to affiliated securities businesses for two distinct reasons. First, bank deposits represent 'subsidised' funding to the extent that depositors are protected by the official safety net. Arguably, bank deposits should not be allowed to provide high-risk, aggressively managed securities businesses with cheap financing that does not reflect the risk involved. Secondly, if a combined banking/securities business fails, it is unreasonable that bank depositors (or the deposit insurance fund) should be expected to meet any deficiencies in the securities unit. If funding firewalls are imposed depositors are at least partially insulated from risks incurred by a bank's related securities entity. In this context it is interesting to note the different risk-reward profiles of a bank-related derivatives trader and a bank depositor: the former faces zero downside risk and potentially unlimited returns (through bonuses) on high-risk positions, whereas the bank depositor faces zero upside returns and potential losses limited only by the size of his/her deposit. Under these circumstances no rational depositor would agree to place funds with an organisation that intended to use the proceeds for trading unless the deposit liabilities were explicitly or implicitly guaranteed.

Under present EU Directives and UK rules, banks are not effectively prohibited from financing their securities operations through bank deposits. Admittedly, EU large exposure rules require banks to obtain prior authorisation for related entity exposures of over 20 per cent of capital, but the requirement is subject to various waivers and discretionary exemptions. Above all, there is nothing to prevent banks from undertaking securities/derivatives trading on their own balance sheets, thereby by-passing intra-group large exposure limits altogether. The EU regime is in stark contrast to the proposals recently put forward by the US Treasury as part-of the planned Glass-Steagall reforms being considered by Congress: the Treasury would (a) repeal Section 20 of the Glass-Steagall Act (which currently prohibits banks from being affiliated with a securities firm); (b) require that securities activities be undertaken by a separately incorporated subsidiary of the bank and (c) impose funding firewalls between the bank and its related securities unit.

LENDER OF LAST RESORT

The Barings episode provides an interesting application of the lender of last resort principles set out by the Governor of the Bank of England in November 1993. The fact that Barings was clearly insolvent, that the reasons for its insolvency were unique to Barings and that its failure was unlikely to have major systemic consequences, evidently ruled out use of the Bank of England's own resources. On the other hand, the banking fraternity were prepared to put up money to save Barings, short of capping the open derivatives positions. Why the clearing banks should have believed it to be in their shareholders' interests to save Barings is not obvious, given that they are the main beneficiaries of the damage to confidence inflicted on the merchant banking sector. Be that as it may, the publicity given to the rescue attempt is perhaps intended to convey the impression that in any other such case—absent open-ended losses—industry support may be forthcoming. In other words the private sector LLR is still intact.

The market consequences of the absence of LLR back-up for Barings are potentially far-reaching. The most predictable short-run response has been a withdrawal of funding from some merchant banks actively involved in derivatives/securities activities. The key question here is whether we are witnessing a temporary contagion effect or whether the market will force these institutions to restructure their operations. After all, if they can no longer rely on deposit funding to finance their securities business, some merchant banks may be inclined to discard their banking licences. In this context Warburgs Bank has stated that it does not lend unsecured to the securities businesses of the group and is now limiting its secured lending. The implication is that self-imposed funding firewalls may be in prospect.

If the smaller bank-securities firms are denied access to cheap deposits their financing costs will rise. In such a situation the big Japanese and American securities houses, as well as the UK clearing banks' securities units, will enjoy a significant competitive advantage over their smaller UK rivals that could lead to mergers and industry restructuring. Big is Beautiful in the aftermath of Barings.

What regulatory reforms should be considered in the light of these events?

First, there is an urgent need for an agreed international regulatory framework for securities business, paralleling the various Basle initiatives. IOSCO's track record in this respect is extremely disappointing and it may be that a new and smaller organisation, representing the major financial centres, should be established to push forward with co-ordination proposals.

Second, funding firewalls should be put on the regulatory agenda, although any moves in this direction would involve a major overhaul of the EU Capital Adequacy Directive. Furthermore the present separation of banking and securities regulation between different agencies can be fully effective only if the risk exposures of these two businesses can also be segregated.

Third, regulatory enforcement mechanisms must be reviewed. In particular, the role of auditors in assessing the adequacy of internal controls may need to be clarified and possibly extended.

Fourth, while regulatory attention has focused on after-the-event controls in the back office there is a case for introducing before-the-event safeguards to discourage unauthorised trading. These might include a requirement that each licensed trader lodge his detailed written trading authority (and trading limits) with the exchange on which he trades. There should also be reciprocal arrangements between financial centres ensuring that a trader debarred in one jurisdiction cannot trade in another.

Finally, securities businesses should be subject to consolidated supervision in the same way as banks.

March 1995

ANNEX

BARINGS PLC (S&S)

- Barings BV
- Holdings
  - Baring Brothers & Co Ltd (S&S/WMSD/SFA) (UK and overseas branches)
    - Baring Securities Ltd (SFA)
      - Baring Securities (London) Ltd (SFA)
      - other subsidiaries
    - Baring Sterling Bonds (SFA/WMSD)
      - Wilson & Watford Nominees
    - Baring Venture Partners Ltd (IMRO)
      - BHB Management (IMRO)
    - Baring Capital Investors Ltd (IMRO)
      - subsidiaries
    - various other subs, and 40% Dillon Read
  - Baring Asset Management Holdings Ltd
    - 33% Baring Int'l Property Services (33% held by Holdings)
      - Baring Houston & Saunders (IMRO)
    - Baring Quantiative Management (IMRO)
    - Baring Int'l Inv Mgmt Holdings
      - Baring Int'l Inv Mgmt (IMRO)
      - many other asset mgmt subs
    - Baring Investment Management (IMRO)
    - Baring Int'l Investment Ltd (IMRO)
    - Baring Private Asset Management
      - Baring Private Investment Mgmt (IMRO)
      - Baring Managed Funds Services (IMRO) Dormant
    - Baring Fund Managers (IMRO/PIA)
    - Other asset management subs
    - 2 foreign Banking subs (Geneva and Guernsey)
- Yealme Insurance (Guernsey regulated captive)

S&S	Bank of England Supervision and Surveillance Division
WMSD	Bank of England Wholesale Markets Supervision Division
SFA	The Securities and Futures Authority Ltd
IMRO	Investment Management Regulatory Organization Ltd
PIA	Personal Investment Authority

APPENDIX 12

Memorandum submitted by Record Treasury Management

BACKGROUND

Record Treasury Management Ltd (RTML) was formed in 1983 as a specialist provider of financial consultancy and management to UK and international institutions and corporations. We have specialised predominantly in the area of currency management using, and analysing, many types of derivative instruments. Over the years we have been responsible for over 27,000 currency deals totalling over $150 billion without error. We have also used derivatives in a number of other markets, and have undertaken consultancy projects on a 'derivatives' disaster and other treasury related matters. We work extensively with the Association of Corporate Treasurers, and have spoken at a wide range of conferences on financial matters.

DERIVATIVES USAGE

RTML has extensive experience of working with corporate finance directors and treasurers in many sectors of UK industry. As a result of this, and to deepen our understanding of the needs of the corporate sector, we have been conducting regular surveys of corporate treasurers for the last three years, and have also undertaken a survey of finance directors in the summer of 1994. The results of this latter survey together with the results from the latest Corporate Treasurers' survey (Autumn 1994) are attached as Appendices B and C. [Not printed] Response rates were 32 per cent and 41 per cent with questionnaires being sent to the largest 250 and 220 British companies respectively. The key points in respect of derivatives are noted below.

— 96 per cent of respondents use interest rate derivatives.

— 85 per cent of companies use currency derivatives.

— The overwhelming majority (93 per cent for interest rates) expect their usage of derivatives to grow or remain the same.

— Derivatives have enabled over 50 per cent to reduce the risk in their business, whilst 11 per cent believed that their absence restricted their commercial activities.

— 77 per cent believed that control was the biggest risk in using derivatives, with significant numbers also stating complexity (57 per cent), counterparty risks (44 per cent) and reporting (37 per cent) as being of concern.

— The majority (55 per cent) felt that regulation should be in the form of central bank supervision. Since the Bank of England's supervising role is largely confined to the banking sector the implication is that controls and monitoring should be aimed at the market makers rather than the users.

— Only 1 per cent believed that sellers of derivative products explained and quantified the risks involved really well. Conversely 54 per cent thought that they were "Poorly" or 'Inadequately' explained.

— Two-thirds of derivative users mark their positions to market on a monthly basis or less frequently.

— Derivative activity consumes less than 10 per cent of treasury resources in the great majority of companies (80 per cent).

PROBLEMS ENCOUNTERED

The vast majority of problems in the derivatives area have their foundation in a failure of control and adequate/timely/directed reporting. This is usually combined with a major or unusual market movement which highlights the problems above. Another common feature is that many have occurred in 'profit oriented' environments ie bank trading rooms, proprietary trading desks or treasuries which are acting as a profit centre. In this situation both individual and departmental orientation may be focused on trying to conceal losses until an improvement in results can be seen. Commonly individuals involved will 'double up' trying to recoup losses, but thereby increasing the risks to their organisations.

It is clear however that disasters at corporations (unlike banks) do not pose a systemic threat to the system (see article from Treasury Today—March 1995 reproduced as Appendix D [Not printed]). Given that the taxpayer may have to provide 'catastrophe' insurance to prevent a systemic disaster from a banking collapse, we feel that clear central bank supervision is both justified and would be welcomed in the wider business world. On the other hand corporations and other end users are not pivotal in the financial system and have no claim upon government aid in the event of a derivatives disaster. In this area we believe that the rules of the marketplace should prevail and that 'caveat emptor' should be the key phrase.

RECOMMENDED ACTIONS

In order to minimise the chances of major derivatives disasters we would recommend that the following steps are taken.

— Clear and thorough segregation of duties between front and back office, with separate reporting to the board or general management of the company. In our view the most transparent route would be to have a completely independent body (similar to an auditors' role) providing this service.

— Central bank supervision of market making activities, clearly identifying and segregating the activities of proprietary traders.

— A mechanism whereby the lessons of disasters or near disasters are understood, disseminated and, where necessary, implemented with statutory backing.

March 1995

APPENDIX 13

Memorandum submitted by Information Systems Audit and Control Association

1. INTRODUCTION

Information Systems Audit and Control Association

The Information Systems Audit and Control Association (ISACA) was founded in 1969. ISACA is an international organisation with headquarters in the USA and has 15,000 members in 150 Chapters or branches throughout the world. It is generally recognised as the professional body for specialists in the areas of Information systems audit, computer audit and the control and security of computer systems. ISACA provides a specialist qualification by examination (Certified Information Systems Auditor) which is available to individuals with suitable experience.

International Background

ISACA is truly international with members in more than 70 countries. It organises regular conferences and meetings in different countries, recently it held its annual International Conference in London in June 1994.

The London Chapter

The London Chapter was set up in 1981 and is now one the largest ISACA chapters in the world with more than 300 members. The UK has two other chapters based in the Midlands and the North. The London Chapter runs professional meetings and conferences, organises training for ISACA's professional exam and publicises computer audit and security matters in the wider community. It has recently started to contribute books and publications to the Guildhall Library of the Corporation of London. Members of the Chapter participate in International conferences and some members sit on International Committees.

The Chapter also organises "special interest groups". These groups are what they say: they provide a forum for members with special interests to meet and share information thereby expanding their knowledge about specialist subjects. The groups' conclusions and findings are generally presented to the wider membership, obviously a specialist subject must be presented in a form which others can appreciate.

The Derivatives Special Interest Group

The committee of the London Chapter set up a special interest group on "Derivatives" in the Autumn of 1994. The decision had been prompted by the increasing publicity and concerns expressed about derivatives together with some significant financial mishaps and catastrophes. The group met for the first time in October 1994 and it was immediately apparent that there was a great deal of interest (the meeting attracted a larger number of attendees than any other group) and those interested were extremely concerned about the use and control of derivatives in their respective organisations.

The opinions and views expressed here represent just that: a view by interested parties, but not necessarily conclusive or final. They are held by auditors with an interest in the control and good management of derivatives.

2. DERIVATIVES

Why use derivatives?

Derivatives are financial products which are unlike something tangible such as a share in a company. They may be based on an underlying security and typically could allow the owner to buy or sell a security at a later date, sometimes at a pre-determined price. Trading procedures can allow individuals and institutions a large financial commitment for relatively little outlay. They are very different from ordinary securities traded in a conventional manner: an ordinary share worth £100 requires you to invest £100. A derivative which gives you the right to buy a share worth £100 may only require a limited initial investment, perhaps a few pounds. A relatively small change in value of the underlying security can lead to a much larger change in the derivative: they are "highly geared".

The argument in favour of derivatives is that their use allows you to "hedge" or cover yourself against risk, risk of unfavourable exchange rate or interest rate movements, perhaps risk that the stock market may rise too much before you are able to buy shares with some money you expect to receive in the future. For example a pension fund knows that it will receive regular contributions and needs to invest the money at regular intervals in the future. There are many risks and there are many derivatives to help meet these risks.

The argument against is that they can be mis-used. Over-investment in derivatives can be equated with speculation and can lead to extraordinary gains and losses. Buying derivatives which represent the future value of a security will be profitable if the underlying security rises, if it falls the effect on the derivative can be magnified out of proportion to any initial investment with extreme losses as have been recently seen at Barings.

So why use derivatives? Properly used they should reduce risk and increase return, mis-used they can lead to bankruptcy.

Why drive a car? Most people believe the benefits outweigh the drawbacks but cars and car users must be controlled.

3. Computers and Derivatives

Computers calculate derivative values

The value and pricing of some derivatives can be based on economic theory and mathematical formulae. Computers are the only practical means of calculating their values. Ideally different computers with the same assumption will come to the same answer. In practice the assumptions are varied perhaps to give a more realistic view but you still need a computer.

Large number of transactions

Computers are used throughout every type of business to process large numbers of transactions quickly and accurately. Derivatives represent a good example. The major markets process thousands and thousands every day, the consequential business processes must be complete before the next day's thousands and thousands are processed.

Monitoring and control

Banks in the UK have an obligation to balance their books every day (Banking Act). Any institution dealing in fast moving markets with large amounts of money at risk will find their exposure varies substantially from day to day. Indeed the "mark to market" principle requires institutions to re-value their investments to the market value every day. Without appropriate computer systems any institution would not be able to keep its values up to date.

Indeed there can be so much information which changes so quickly that computers must be used not only to keep values up to date but also to identify where values have changed and thus putting the institution at risk. *We believe that this is a serious area of concern and one where computers are not being used to their full capacity.* Much of the necessary monitoring and control can be done on an exception basis: unusual items or exceptional changes can be identified and appropriate action taken.

Computers are inflexible

Computers are inflexible and so they should be. Once someone has programmed a computer to identify where values have changed since the previous day and the corresponding risk attached to the changes then the computer report should be used every day. The institution's management can ignore the report at its peril until a more up to date report can be produced.

The Bank for International Settlements recommendations

The Basle Committee on Banking Supervision has published "Risk Management Guidelines for Derivatives". The document recommends that dealing institutions should have the ability to monitor risk by measurement and aggregation across all activities on an institution-wide basis, in other words the institution should be able to pull together information from all deals, in any market across the world. This can only be done with suitable computer systems.

Furthermore the Basle Committee recommend that monitoring be performed daily. Additionally in an extraordinary statement the committee suggest that some institutions should have the capacity, or at least the goal, of monitoring their more actively traded products on a real-time basis. "Real-time" means literally up to the minute, in other words an institution should know immediately what its total world wide risk is. This is a very demanding requirement which could be met if an institution's central computer was directly linked to every dealing room in the world and all deals were promptly and accurately recorded. We do not know of any institution which has such a computer system.

Conclusion

We conclude that computers are essential for the derivatives business especially in their ability to monitor and control information from many sources in as short a time as possible. This task cannot be performed manually if only because by the time a human being could do it the information would be out of date.

4. Word of the Computer Auditor

Control the controller

The work of the auditor is not to control the day to day operations of a business, that is the task of management. The management of an institution must introduce suitable and satisfactory controls to ensure that a business operates successfully without undue risk. It is the job of the auditor to ensure that controls are in place and are observed by management and staff.

Some controls are straightforward such as the separation of responsibilities: no one person should have responsibility for making a deal and for handling the administration and confirmation which results from that deal.

Some controls may require a computer system. Typically the auditor will be concerned with controls which are unique to computer systems, termed programmed procedures and integrity controls. Frequently computer systems now produce summarised information or report only exceptional or unusual items as the basis for controls. It is neither practical nor cost-effective for the user to check manually this sort of information. Consequently the auditor must decide whether to rely on the computer controls or test them directly. (Jenkins, Perry and Cooke).

Knowledge and experience

The auditor must have the computer knowledge and skills to understand controls within the computer system, if the auditor does not think they are adequate he or she should test them, if they are proved inadequate he should report the inadequacy to management who should improve the controls or implement alternative ones.

We conclude that institutions which have problems with monitoring and controlling derivatives may have poor management, poor controls or poor auditors.

Danger of poaching

Clearly the role of the computer auditor is important. He must be well paid, if not an institution will not attract good enough people with the appropriate knowledge.

5. Opinions on Specific Matters

The Financial Services Act and the Over The Counter market

"Over the Counter" (OTC) derivatives are generally special or unique transactions between institutions. They are not generally traded on markets. Schedule 1 of The Financial Services Act defines and distinguishes investment and commercial business. Paragraph 8 of Schedule 1 and its notes describe Futures. Note (5) generally applies for an OTC Futures contract implying the contract is for commercial and not investment purposes. Note (6) would imply an OTC Futures contract is for investment purposes but (a) and (b) do not apply. We conclude that the Act may not cover certain derivatives which are traded Over the Counter.

Systemic threats

Proper use of derivatives should not pose a systemic threat. Proper use means the use of derivatives as they were conceived ie a method of hedging or covering against unexpected losses or unexpected movements in markets. In stricter terms the use of derivatives should reduce an institution's exposure to market risk measured by the volatility or variability of market prices (Basle Committee on Banking Supervision).

Institutions which over-use derivatives ("aggressive hedging") may adversely affect the market. Excessive use of derivatives can affect the price of underlying securities, an example being the Tokyo stock market falling 3.8 per cent after Barings Bank went into administration), the security's price and volatility in turn affects the value of derivatives and a systemic threat to markets could arise.

"Credit risk" is the risk that a counterparty will fail to perform an obligation to the institution initiating the derivatives (Basle Committee on Banking Supervision). Clearly excessive use of derivatives between institutions could lead to systemic risk as if one institution failed to perform an obligation adversely affecting another, the second institution could in turn fail to perform its obligations with a knock-on effect to other institutions. Judicious use of "credit limits" should limit an institution's exposure.

An institution can use suitable controls to limit market and credit risk. Auditors must ensure the controls are in place.

The regulators response

The response of the regulators worldwide clearly varies as recent events have shown. The responsibilities for monitoring derivative transactions and exposures would be better if it were co-ordinated and immediate: clearly this could be achieved only with adequate computer systems linking regulators.

Public disclosure of Credit risk strategies

We assume Credit Risk Strategies refer to an institution's procedures to monitor and control credit risk. Potential credit risk exposure ... is primarily a function of time remaining to maturity and expected volatility of the price, rate or index underlying the contract (Basle Committee on Banking Supervision).

While it may be a truism to say that greater public disclosure may be for the general good by preventing excessive turbulence the disclosure may require the release of proprietary and sensitive information. An institution could be placed at a commercial disadvantage in its dealings with counterparties. In addition the public disclosure may lead to adverse speculation against an institution thus encouraging excessive turbulence.

Improved accounting practices

Accounting systems and practices principally record and present historical information. Where the accounting practices can be used to manage and control exposure and risk of future movements they should be encouraged.

28 March 1995

APPENDIX 14

Memorandum submitted by Professor Brian Tew, OBE, Specialist Adviser to the Committee

RISK ASSESSMENT

I recall a conversation I had many years ago with Professor Alec Grant, at a time when he was in charge of the Export Credit Guarantee Department. He explained that his main headache was how to fix premia on credit extended to the Communist countries. On the basis of past experience the risks he was insuring were non existent, since at that time no Communist country had ever defaulted on any credit. On the other hand he realised that past experience was not an infallible guide to future claims, since a change in political regime (such as the one which subsequently occurred) could trigger very large claims.

Alec Grant's problem is one which bedevils risk assessment in banks. On the one hand, there are risks, great and small, which can be assessed accurately, within known confidence limits, on the basis of data arising from a large number of past transactions. Computerised "value at risk" models are the latest and most highly sophisticated device for performing the necessary risk calculations, and for working out what interest rates, fees, premia etc must be charged if the bank is to avoid operating at a loss. Hence "value at risk" models are an essential tool of modern business management.

On the other hand, there are risks of the unknown, of the kind that worried Alec Grant. In the case of today's private sector banks, such risks might be, for example, an unforeseen collapse of a major currency, the failure of a money centre bank, a base rate of 25 per cent, an unfavourable legal decision, an epidemic of bad debts throughout a whole industry, etc. The appropriate device for assessing such risks is so-called "stress testing", in which the bank's computer is not asked to calculate probable risks in the light of past experience but instead to calculate the overall net loss which the bank would suffer from various specimen catastrophes thought up by the risk supervisor.

In my opinion it is stress testing which is the aspect of risk assessment most relevant to the responsibilities of an official regulatory agency, since it is the unprecedented and unforeseen risk which is the main threat to the solvency of a bank. So the main concern of the Bank of England, in its supervisory role, is to vet the stress testing routines of the banks for which it is the lead regulator. The difficulty of vetting on a fair basis, as between one bank and another, has clearly increased to the extent that the Bank needs to concede that the appropriate stress testing routine differs from one bank to another.

May 1995

APPENDIX 15

Letter from Mr Jonathan Evans, MP, Parliamentary Under Secretary of State for Corporate and Consumer Affairs, Department of Trade and Industry

(LETTER PLACED IN LIBRARY OF THE HOUSE)

In reply to your question (Official Report 7 June 1995 Cols 239–240) I undertook to write to you when information was available about prosecutions under the Financial Services Act. Information has now been obtained from my own Department, the Securities and Investments Board, the Crown Prosecution Service and the Serious Fraud Office.

Since April 1992 my Department has brought 4 prosecutions against 9 defendants involving offences under the Financial Services Act; 5 of the individuals were convicted and 4 acquitted. There was at least one conviction in all four prosecutions.

The Securities and Investments Board has brought one prosecution under the Financial Services Act and the defendant was found not guilty. However it has referred cases to other prosecuting authorities.

The Crown Prosecution Service has commenced proceedings under the Financial Services Act on a number of occasions but their prosecution statistics do not specify the offences involved.

As at 5 April 1995 the Serious Fraud Office had charged 14 defendants with Financial Services Act offences, 8 of whom were convicted. These charges covered 6 trials.

For the avoidance of doubt, I should perhaps make it clear that the above information does not include prosecutions for insider dealing. Although the power to appoint inspectors to investigate possible offences is found at Section 177 of the Financial Services Act the offence of insider dealing is not contained in the Financial Services Act but under Part V of the Criminal Justice Act 1993 which itself replaced the Company Securities (Insider Dealing) Act 1985.

I hope that this information is helpful. A copy of this letter is being placed in the Library of the House.

17 June 1995

APPENDIX 16

Memorandum submitted by Mr Christopher Johnson, Specialist Adviser to the Committee

THE REGULATION OF DERIVATIVES

We begin with a brief statistical overview of the international derivatives market. The main part of the paper reviews the literature on derivatives regulation, bringing out the main issues in the debate, and ends with a comment on Barings and the Bank of England. The final section gives some general conclusions.

Statistical Overview

Table 1 shows that derivatives markets have expanded at a compound annual rate averaging 40 per cent a year since 1986. The notional principal sums have thus multiplied by nearly 15 in current dollar terms.

The rate of growth of derivatives markets peaked in 1988 and again in 1993, and slowed down markedly in 1994.

The market is more or less equally divided between exchange traded ("off-the-peg") and over-the-counter ("made-to-measure") products.

According to the Bank for International Settlements, over nine-tenths of the market consists of interest-rate-related products, with currency-related products accounting for 6 per cent and stock-market-related products about 2 per cent.

The BIS figures do not include forward contracts. If these are included, as they are by the US General Accounting Office, forward interest rate agreements add about 25 per cent to the sum of interest rate derivatives, while forward foreign exchange contracts are nearly six times as much as all foreign exchange derivatives. This method of calculation changes the split to 62 per cent of total derivatives, including forwards, related to interest rates, and 37 per cent to exchange rates.

Futures and options are mainly traded on exchanges, while swaps are mainly traded over-the-counter.

Interest-rate and currency swaps have grown faster than interest-rate and currency futures or options.

Recent figures from the UK in table 2 show that the credit risk of derivatives is only a small fraction of the notional principal, because the sums at risk are essentially interest rate differentials and not principal amounts, and opposing risks can often be netted against each other.

The credit equivalent exposures of UK banks active in the over-the-counter swaps market fell from 2.1 to 1.4 per cent of the notional principal of interest-rate related derivatives between end-1993 and end-1994. Exchange-rate related derivatives exposure remained at about 3.7 per cent over the same period. This reflects the higher potential exposure of exchange rate positions to market fluctuations.

The notional principal of active UK banks' OTC derivatives rose from 4.5 to 5.7 times their balance sheets, but the credit exposure remained at about 11.7 per cent of their balance sheets, and 5.4 per cent of their risk-weighted assets.

These figures do not include exchange-traded derivatives such as futures and options, where the credit risk is that of the exchange rather than that of individual counter-parties, and is therefore considerably less. However, market and other risks attach to both kinds of derivative, so the picture given by table 2 does not tell the whole story.

In the USA some banks which specialize in derivatives, notably Bankers' Trust, have notional principals of derivative contracts up to 20 times their balance sheet. Another difference is that interest-rate-related derivatives dominate the American market even more than the international market, while in other countries with important foreign exchange markets, such as the UK, currency-related derivatives account for a higher proportion of the total.

DERIVATIVES MARKETS 1986–1994 TABLE 1

End-year outstandings of notional principal $bn

	1986	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*% growth*
Exchange-traded:										1987–1994
Interest rates futures	370	488	895	1,201	1,454	2,157	2,913	4,942	5,757	41
Interest rate options	146	122	279	388	600	1,072	1,385	2,362	2,623	43
Currency futures	10	14	12	16	17	18	25	32	33	16
Currency options	39	60	48	50	56	63	71	75	55	4
Stock market index futures	15	18	28	41	69	76	80	110	128	31
Options on stock market indices	3	23	38	71	94	133	159	238	242	73
Total exchange traded	583	725	1,300	1,767	2,290	3,519	4,633	7,759	8,838	40
% change		24	79	36	30	54	32	67	14	
Over-the-counter:										1987–1993
Interest rate swaps	400	683	1,010	1,503	2,311	3,065	3,851	6,177		48
Currency swaps	100	184	320	449	578	807	860	900		37

DERIVATIVES MARKETS 1986–1994 *TABLE 1— (continued)*

End-year outstandings of notional principal $bn

	1990	*1991*	*1992*	*1993*	*% growth* 1991–1993
Caps, collars, floors, swaptions	561	577	635	1,398	36
Total over-the-counter	3,450	4,449	5,346	8,475	35
% change		29	20	59	
Grand total	5,740	7,968	9,979	16,234	41
% change		39	25	63	

Source: BIS

DERIVATIVES EXPOSURES: ACTIVE UK BANKS TABLE 2

Over-the-counter credit equivalent exposures

	£ billions end-1993	*end-1994*
Interest rate swaps:		
1. Notional principal	2,333	3,356
2. Credit equivalent exposure	49	47
2. as % of 1.	2.1	1.4
Currency swaps:		
3. Notional principal	1,066	1,400
4. Credit equivalent exposure	40	50
4. as % of 3.	3.8	3.6
Total swaps:		
5. Notional principal	3,399	4,756
6. Credit equivalent exposure	89	97
6. as % of 5.	2.6	2.0
7. Balance sheet	755	833
5. as multiple of 7.	4.5	5.7
6. as % of 7.	11.8	11.6

Source: Derived from BEQB May 1995 p189 table A
Docname: DE

Survey of Derivative Literature

The literature surveyed here falls into three main categories: the international publications based on the Bank of International Settlements; the US publications coming from the American banking regulators and other Washington agencies; and the UK publications from the Bank of England. This survey is chronologically based, as are the references at the end.

The Basle Accord

The BIS December 1994 report *Prudential Supervision of Banks' Derivative Activities* well sumarizes the history of international regulation of derivatives. The Committee on Banking Regulations and Supervisory Practices, later renamed the Basle Committee on Banking Supervision, began to consider the matter systematically in 1984. The result was *Recent Innovations in International Banking*, a detailed report by a study group of the G-10 central banks chaired by Sam Cross of the New York Fed, published in April 1986. It remains to this day a simple and authoritative explanation of the various kinds of derivatives.

The Cross Report broadly welcomed the new financial instruments. "Innovation has improved the efficiency of international financial markets, mainly by offering a broader and more flexible range of instruments both for borrowing and for hedging interest and exchange rate exposures. These changes have clearly aided banks and their customers to cope with stresses associated with the greater volatility of exchange and interest rates in recent years." This has continued to be the majority view over the decade since these words were written.

The report did, however, highlight a number of concerns. It listed the normal risks in any financial transactions, but suggested that some of them might be increased by the new instruments:

Underpricing due to competition in unknown territory. "Gross income from the transactions is insufficient, on average, to compensate fully for their inherent risks."

Financial systems risk. "The risk that the liquidity of these assets will disappear is likely to be greatest when it is most needed." "The general trend toward increased off-balance-sheet activity and "unbundling", as well as the complexity of multiple linked transactions, can mask the interlocking of risks, for bank management, regulators and market participants alike ... The new instruments transfer price or market risk from one economic agent to another, but do not eliminate that risk."

Settlement risk. "The rapid growth in the volume of transactions ... can also contribute to potential systemic risks ... There is a risk of overloading or congestive interruption of the payments system." Ten years later, the general move to real time gross settlement systems, designed to deal with such risks, is not yet complete.

Volatility in financial markets. "Prices in cash markets were subject to no more, and often less, fluctuation after the introduction of futures markets. At the same time, there are particular day-to-day situations in which the hedging activities of market participants, especially in options, do seem to increase the volatility of the price of the underlying asset."

Regulatory problems. "A case can be made for reducing the risk posed by the potential failure of large non-bank financial firms by extending bank-like regulation and supervision to them, even though they do not themselves take deposits from the public and would not fit neatly under the particular supervisory standards applicable to banks. Extension of supervisory responsibilities, however, would run the risk of suggesting that similar central-bank liquidity support was available to such institutions as is currently available to banks."

Also in 1986, the Basle Committee published *The Management of Banks' Off-Balance-Sheet Exposures: A Supervisory Perspective*, which was the basis, two years later in 1988, for its *International Convergence of Capital Measurement and Capital Standards*, known as the Basle Accord. This was the first attempt to create a "level playing field" for international banking competition. It set out two different approaches among supervisors to derivatives when it came to attaching a risk weight to off-balance-sheet items for capital purposes.

The original exposure method takes notional principal and applies a percentage to it (1 per cent for 1–2 year interest rate contracts and 5 per cent for 1–2 year exchange rate contracts, for example). The current exposure method takes the total replacement cost of all positive value contracts by marking them to market, and adds an "add-on" for potential future credit exposure (later to be known as "value-at-risk"), based on somewhat lower percentages of notional principal than under the original exposure method.

The Accord also recognized certain kinds of netting between counterparties as reducing risk, and some countries allowed private sector risk to be weighted at only 50 per cent rather than the normal 100 per cent, in view of the generally high credit rating of derivatives market participants. Given that the basic capital requirement was 8 per cent of risk-weighted assets, it can be seen that an interest rate swap with a notional principal of £1 million might count as a risk-weighted credit exposure of only £5,000 (50 per cent of 1 per cent), and require capital of only £400 to back it.

The 1988 Accord dealt only with credit risk, and not with market risk and interest-rate risk, which were seen to be equally important, but more difficult to reach agreement on. Here it was necessary to try to level the playing field between banks and non-bank securities houses, and in most countries each is supervised by a different regulator. The Basle Committee of central bankers found it particularly difficult to agree with the International Organisation of Securities Commissions (IOSCO), the equivalent international body of securities regulators, because of the more flexible capital requirements normally applied to securities firms.

During the next four years two important studies on netting derivatives between banks came out of the BIS, *Interbank Netting Schemes* and *Developments in International Interbank Relations*, known as the Lamfalussy Report and the Promisel Report after their chairmen. They recognized the importance of putting netting on a firm legal basis if it was to be used to reduce derivatives risk, and reflected the fact that many derivatives contracts were between banks.

Regulators measure new dimensions of risk

In January 1992 a much-remarked on warning came from a leading US regulator, Gerald Corrigan, who combined the posts of President of the Federal Reserve Bank of New York, and Chairman of the Basle Committee. "I have to ask myself whether some of the specific purposes for which swaps are now being used may not be quite at odds with an appropriately conservative view of the nature of a swap, thereby introducing new elements of risk or distortion into the marketplace ... I hope this sounds like a warning, because it is." (*Federal Reserve Bank of New York Quarterly Review*, Summer 1991.)

At about the same time Felix Rohatyn, Senior Partner of Lazard Freres, was quoted in *Institutional Investor* as saying "26-year olds with computers are creating financial hydrogen bombs."

It was not until April 1993 that the Basle Committee was able to publish consultative proposals on netting, market risk and interest rate risk. These were designed to apply both to underlying marketable assets, and to the derivatives based on them. They were received with considerable criticism, particularly by banks in the securities business which were afraid of being disadvantaged in international competition with non-bank securities firms by excessive capital requirements.

It was also in the first half of 1993 that the three main US banking regulators, the Bank of England, and the Group of Thirty representing commercial banks, published major reports on derivatives.

The US study, *Derivative Product Activities of Commercial Banks*, was in response to a hostile series of questions by Senator Riegle of the Senate Banking Committee. The regulators played down the dangers of derivatives by pointing out that they were handled mainly by large banks which were already being effectively supervised. They emphasized the use of on-site bank examinations in such cases, and concluded that more effective management of risk by banks would be better than more regulation.

The Bank of England study, *Derivatives: Report of an Internal Working Group*, was based on interviews with market participants. The main aspect of concern related to the Bank of England as supervisor, with regard to market, credit, and operational risk. In the light of events since 1993, the conclusions on these points are worth recalling.

Market risk. "Supervisors need to ensure that the limitations of models are understood, that valuation is done on appropriate assumptions and consistently across products, and that risk limit structures take account of all the quantifiable risks that can affect the portfolio. Where the scenarios modelled do not include market extremes, such as liquidity gapping, the firm's strategy and record with regard to coping with such extremes need to be examined."

Credit risk. "Supervisors need to investigate the measurement of counterparty exposure and, for all banks actively involved in derivatives, encourage the swift adoption of marking-to-market of credit exposures and accurate aggregation of such exposures. We need to ensure that credit risk in derivatives is properly understood and controlled, in particular to establish how it is priced."

Operational risk. "Supervisors should consider the extent to which senior management do (or are likely to) understand the derivatives area of a firm's business. A guiding principle might be that, where this activity is important to a bank, at least two members of the Board (including the Finance Director) should be sufficiently knowledgeable to be able to ensure that the business is controlled effectively."

Regulatory coverage. "Supervisors need to place a high priority on closure of regulatory gaps, for instance those in securities house groups and insurance companies."

It does not appear that the Bank of England moved fast enough to implement the recommendations addressed to itself as supervisor by its own internal working group. The derivatives market appears to have expanded much faster than the ability of the Bank of England to supervise it by working effectively through the managements of the UK banks active in derivatives.

The banks' plea for self-regulation

The Group of Thirty (G-30) report, *Derivatives: Practices and Principles*, under a steering group chaired by Sir Dennis Weatherstone, Chairman of J.P. Morgan, one of the main banks in the market, sidestepped the whole question of regulation, on the grounds that derivatives were no different from any other banking activity, and concentrated on a list of 20 recommendations for better risk management by participants, with only four addressed to official agencies. It amounted to a plea for self-regulation.

The recommendations started with a call for the attention of senior management, and covered areas such as valuation and market risk management, credit risk measurement and management, enforceability, systems, operations and controls, and accounting and disclosure. The final four recommendations were addressed to supervisors, asking them to help the industry by recognizing netting, removing legal and regulatory uncertainties, ending disadvantageous tax treatment, and harmonizing international accounting standards. In other words, they were asked to help the derivatives industry, not to constrain it.

The *Financial Times* leader on the report accused it of "complacency" for proposing no change in the existing regulatory arrangements. "It would clearly be foolish to take anything on trust from the banks."

(FT 26 July 1993). Like the FT, the banking supervisors whom the Group of Thirty invited to comment on its report in its paper *Global Derivatives: Public Sector Responses* felt that it had underplayed the potential systemic risks arising out of derivatives.

Mr Brian Quinn, the Bank of England Executive Director in charge of supervision, gave his reaction to the report at a seminar on it held by the G-30 in September 1993. He pointed to the "broad measure of agreement" between the G-30 and Bank of England reports, and praised it for making explicit what had been implicit in the Bank's report: "The primary responsibility for understanding and managing these products lies with the management of the individual firm."

Mr Quinn did, however, side with the *Financial Times* in regarding as "somewhat complacent" the G-30 view that, because derivatives did not introduce risks of a fundamentally different kind, supervisory concerns could be addressed within the present supervisory framework. He went on: "Expertise in derivatives trading is limited. If the demand for this new source of profit should expand more quickly than the supply of people capable of doing the business, there can only be trouble ahead. Derivatives trading is for grown-ups".

He also expressed concern about the degree of concentration in the derivatives market, the potential shortage of liquidity, and the spread of failures through market linkages. His main criticism was of the G-30 view that "participants can evaluate for themselves the risks and benefits of trading with unregulated entities". He rebutted this: "I myself can see no justification for the failure to include in consolidated supervision the activities of wholly-owned unregulated subsidiaries of banks, securities or other financial companies conducting derivatives trading." (BEQB November 1993).

At a conference in July 1994, Mr Quinn reiterated some of his earlier concerns, but claimed that good progress was being made on the regulation of derivatives. "The supervisors and regulators in the main centres are working hard in specialised groups to find solutions that deliver regulation without strangulation. Perhaps equally important, the market is developing its own form of safeguards by insisting on greater disclosure and transparency, improved accounting rules, collateralisation and margining requirements that protect both them and the ultimate users of the product." (BEQB August 1994).

Warnings from the IMF

The IMF was far less complacent than the G-30 in its assessment of the derivatives market in August 1993, in a special section of the its annual report on *International Capital Markets* entitled "The growing involvement of banks in derivatives finance—a challenge for financial policy." The IMF emphasized not only the various types of risk involved, but also the failure of many participants to understand them. "There are concerns that the speed at which these markets have expanded and the complexity of many of the instruments have weakened risk management. Some of the recent products may not be well understood either by senior management of banks or by supervisors of securities firms."

The IMF concluded with a question: "Could risk reduction also be achieved by channelling more of the OTC business to the organized exchanges? Margin requirements and loss-sharing arrangements have gone a long way towards eliminating credit risk among members of the exchanges, as well as the risk of spillover from a major default."

The question was answered in the affirmative by the author of the IMF report, David Folkerts-Landau, as co-author of the Amex Bank prize-winning essay of Autumn 1994, more colourfully entitled "The wild beast of derivatives: to be chained up, fenced in, or tamed?" The essay ended: "We conclude that significant benefits can be reaped by inducing migration of much of the standardised plain vanilla OTC derivative contracts—about three-quarters of total OTC volume—into an exchange/clearing house structure."

Exchange-traded products are futures and options, while OTC products are swaps, so the proposal would amount to transferring three-quarters of swaps business on to exchanges and clearing houses. From the figures in table 1, it can be seen that this would mean an increase of about 80 per cent in the turnover of the exchanges. It is not clear that they would be able to handle the additional risk, particularly if the weaker banks now in the swaps market had to be admitted to exchange membership.

The exchanges would be handling a different kind of product from those they now handle, and new exchanges would have to be set up. Tensions would arise between large banks, which now dominate the swaps market, and smaller banks, which would hope to increase market share by joining exchanges. Similar tensions exist over membership of bank clearing houses handling money transmission at present.

The IMF returned to the same theme in its *International Capital Markets* report of September 1994: "The losses incurred recently by several commercial firms undertaking derivative transactions [Codelco and Metalgesellschaft were cited] reinforces oft-repeated concerns that when a financial activity is growing very rapidly and attracting many new entrants, the probability of less experienced players getting into difficulty rises, with potentially adverse spillover effects for their lenders and counterparties."

The IMF recommended more uniform regulatory treatment between banks and securities houses, and stricter disclosure standards, but pointed out that the latter might not surmount the problem that a bank's derivative positions could change very rapidly. "The authorities are concentrating much of their effort—and appropriately—on evaluating the quality of risk management in banking institutions, rather than on trying to track and assess exposure on a day-to-day basis."

The GAO calls for stronger action

The US General Accounting Office, representing neither commercial banks nor official regulators, gave the most critical official view to date in May 1994. Its report to Congress, entitled *Financial Derivatives: Actions needed to protect the Financial System*, went a good deal further than the joint report of the three US regulators referred to above. Although many of its findings are specific to the US system, they are also relevant to other countries.

The GAO pointed to regulatory gaps of the kind referred to by Mr Quinn of the Bank of England. Securities and insurance affiliates were not subject, as banks were, to regulatory examinations or capital requirements specific to derivatives. The report called on Congress to subject these entities to regulation, perhaps by the Securities and Exchange Commission (SEC).

Capital requirements did not cover the whole range of risks attaching to derivatives, the GAO pointed out. Accounting information on derivatives was insufficient, especially in relation to hedging by end-users. The GAO was particularly concerned about derivatives losses by State and municipal governments and their pension funds; the Orange County case was subsequently to justify its concern. There was not enough international harmonization of different regulatory regimes applying to derivatives.

The GAO's recommendations to financial regulators form a benchmark against which regulation in the UK or any other country might be measured. They should:

> "Develop and maintain accurate, current, and centralized information that is accessible to all regulators, including information on the extent of major OTC dealers' counterparty concentrations and the sources and amounts of their derivatives earnings.
>
> "Develop and adopt a consistent set of capital standards for OTC derivatives dealers sufficient to ensure that all of the major risks associated with derivatives are reflected in capital.
>
> "Establish specific requirements for independent, knowledgeable audit committees and internal control reporting for all major OTC derivatives dealers. Internal control reporting by boards of directors, managers and external auditors should include assessments of derivatives risk-management systems.
>
> "Perform comprehensive, annual examinations of the adequacy of major OTC derivatives dealers' risk management systems using a consistent set of standards established for this purpose and including consideration of the internal control assessments performed by boards of directors, management and auditors.
>
> "Provide leadership in working with industry representatives and regulators from other major countries to harmonize disclosure, capital, examination and accounting standards for derivatives."

A new approach to risk management

If the regulators were critical of the banks, as represented by the G-30, the G-30 countered with well-argued criticisms of the consultative papers of the Basle Committee on capital requirements for market risk and interest-rate risk. Charles Taylor of the G-30 published a seminal paper for the Centre for the Study of Financial Innovation in July 1994, entitled *A New Approach to Capital Adequacy Regulation for Banks.*

Taylor argued that the Basle proposals on market risk represented an unnecessary regulatory burden while failing to deal fully with potential risks. His basic new idea was that "the amount of capital a bank needs is related to the financial riskiness of its businesses measured by the volatility of its income. The amount of capital a bank needs is related to the value it has at risk—the uncertainty about future asset and liability values and the value-added in its future activities. This value should be estimated by disaggregating risks ... by evaluating those risks and by reaggregating them, taking into account reasonable estimates of correlations among them."

The Basle Committee responded positively to such suggestions. In a series of papers published in 1994–95, it elaborated the concept of "value at risk", meaning the adverse future change that could take place in a bank's marked-to-market derivative positions, which had already been implicit in the "add-ons" of the 1988 Basle Accord. It also recognized the validity of banks' own internal models to measure "value at risk", based on the extrapolation by econometric techniques of past patterns of volatility.

In its paper *Risk Management Guidelines for Derivatives*, published in July 1994, the Basle Committee pointed out: "One outstanding feature of financial markets is the increasing use of sophisticated models by major institutions as their principal means of managing and measuring risk. As a consequence, supervisory agencies will need to assure they (and external auditors) have staff with sufficient mathematical knowledge to understand the issues and that the reliability of models can be independently verified by external experts."

The Basle guidelines assigned an important role to boards, senior management, and internal audits in overseeing derivatives, and laid down that those exercising the risk management function should be independent of the individuals dealing in derivatives. They called for global limits for each type of risk, to be exceeded only by agreement of senior management, and for an analysis of "worst case" scenarios. They specified separate procedures for dealing with each type of risk—credit, market, liquidity, operational and legal.

According to a survey by Touche Ross, "the analysis of 100 financial institutions in the UK found evidence that the majority appear to have totally inadequate risk management systems." (*Financial Times*, 5 April 1995). This suggests that failure to implement the Basle guidelines was not confined to Barings.

The Touche Ross survey raises the question whether the Bank of England as supervisor should allow such institutions to continue to trade in the derivatives market. Miss Diane Abbott MP asked Mr Brian Quinn a question on this point when he was giving evidence to the Treasury Committee on 5 April 1995. (Q4193)

> Miss Abbott: "Can I ask you a cynical question: do you think that if the bank or financial institution does not have the IT, does not have the computer system to actually measure its risk, to measure its exposure, that it should be allowed to trade in derivatives?"
>
> Mr Quinn: "The straight answer to that is no. I think we take great care to satisfy ourselves that institutions, whether it is derivatives trading or any other kind of business, mortgage lending, or whatever you like, that they have the capacity and skills to do it."

It seems, in the light of the Barings episode, that the Bank of England may be too easily satisfied that institutions are capable of managing derivatives risk. An outright ban on derivatives trading by one or two firms would be taken as proof of sharper vigilance by the Bank. Or it could do as the Federal Reserve Board has recently done to Bankers' Trust, the leading US derivatives participant, and impose controls on its derivatives activity.

Fresh thinking from the BIS

The next paper from Basle was the Fisher Report on *Public Disclosure of Market and Credit Risks by Financial Intermediaries* in September 1994, which argued that market participants should practise fuller disclosure of market and credit risks, so as to enable others to assess more accurately the risks of dealing with them. (At least one leading derivatives bank, J.P. Morgan, has started to publish the models which it uses to assess its own risks, in line with this recommendation.)

The Fisher Report was complemented by the Brockmeijer Report, *Issues of Measurement related to Market Size and Macroprudential Risks in Derivative Markets*, published in Basle in February 1995. This called for the gathering and publication of fuller and more frequent information on derivatives by means of both regular reports by leading participants, and wider occasional surveys, particularly in the OTC market.

The wider implications of derivatives were studied by the Hannoun Report on *Macroeconomic and Monetary Policy Issues raised by the Growth of Derivative Markets*, published in Basle in November 1994. It argued that "developments in derivatives markets are unlikely to have altered significantly the transmission channels of monetary policy or the efficacy of traditional monetary instruments. Derivatives are much more a consequence than a cause of instability in exchange and interest rates, although in times of stress they may contribute temporarily to increase asset price volatility. Consequently, in a derivative-influenced environment, central banks will need to take greater care to ensure that their policies do not contribute to uncertainty, but rather facilitate the formation of stable non-inflationary expectations."

Such views are clearly intended to rebut arguments in favour of limiting derivative and other financial market activity, on the grounds that it can lead to systemic risk and international monetary instability. An extreme example of this approach was President Chirac's remark at the Halifax Summit at the end of June 1995 that financial markets were the Aids of the world economy.

Models to measure market risk

The Basle Committee revised its 1993 approach to market risk in a series of proposals published in April 1995 and due to come into effect, after discussion, at the end of 1997. The main papers covered market risk in general, including derivatives, but there was one paper specific to derivatives, *Treatment of Potential Exposure for Off-Balance-Sheet Items*. This was an important modification of the 1988 Capital Accord. It still allowed banks to choose between the current exposure method of measuring risk (the market replacement cost plus an "add-on" for potential future exposure or value-at-risk) and the original exposure method based on the notional principal, assuming that major banks would prefer the first, more sophisticated method. It added higher weightings for equities and commodities, in addition to interest rate and exchange rate exposures, and for items of over five years.

The Basle Committee also published a consultative proposal about banks' use of models to measure value-at-risk, entitled *An Internal Model-based Approach to Market Risk Capital Requirements*. Many of the points made were such as could have been spotted by trained econometricians before the use of models began.

For example, the predictions made are highly sensitive to the time period over which past data are measured. If the previous year is taken, and it happens to include high volatility of the asset in question, then the value-at-risk factor will be correspondingly high. The Committee proposes using a period of at least one year; this may seem a long time if daily data are being measured, but it may still be untypical of behaviour over a longer period, so banks are allowed to opt for longer periods if they wish.

The problem with such models is that they generally assign a low probability to events outside the normal range of recent experience. The Basle Committee therefore specifies that "all banks using the models approach employ a 99 per cent one-tailed confidence interval. A confidence level of 99 per cent means that there is only a 1 per cent probability based on historical experience that the combination of positions in a bank's portfolio would result in a loss higher than the measured value-at-risk." However, when catastrophes occur—the Kobe earthquake, and its effects on the Tokyo Stock Market, for instance—it is little consolation to be told that the model predicted that it was only a 1 per cent chance. Systemic risks arise out of precisely those events which are *a priori* highly unlikely, but are bound to occur from time to time.

The Committee therefore makes the remarkable proposal that value-at-risk as measured by banks' models should be multiplied by a factor of at least three, to be on the safe side. Unless the same is done for securities houses and other market participants, banks will be at a disadvantage in needing much higher capital requirements for their derivatives positions. This suggestion is tantamount to a vote of no confidence in the use of econometric models to predict markets—a conclusion reached many years ago by most econometricians. It is doubtful whether the resources now being put into such models can be justified by their ability to reduce risk, or whether any amount of capital can protect a bank against either bad risk management or sheer bad luck.

The voluntary approach on Wall Street

Meanwhile, the American Securities and Exchange Commission and the Commodity Futures Trading Commission promoted a voluntary approach on the part of unregulated affiliates of securities dealers and commission merchants. As a result, the Derivatives Policy Group was set up under the joint chairmanship of two "gamekeepers turned poachers", former regulators now turned Wall Street investment bankers: Gerald Corrigan of Goldman Sachs, and John Heimann of Merrill Lynch. The other members were chosen from these two plus four other leading Wall Street firms.

The DPG's first report, *Framework for Voluntary Oversight*, was published in March 1995. Its main idea was that members should voluntarily provide information to the SEC and the CFTC, the regulators of securities houses and derivatives exchanges, to enable them to assess their risk management, including the models used to measure value-at-risk.

To those who see the SEC as a prime example of statutory regulation, this seems like a degree of self-regulation which the UK Securities and Futures Association would not be able to accept, because of the constraints of the EU Capital Adequacy Directive. However, the Bank of England, in its notice *Implementation in the United Kingdom of the Capital Adequacy Directive*, takes the view that "the CAD permits the Bank to recognize the output of certain internal bank models in the calculation of capital requirements for market risk".

Clearly, self-regulation for securities houses and derivatives exchanges might give them a decisive advantage in competition with commercial banks subjected to official regulation designed to protect the deposits of the general public and to forestall the need for lender-of-last resort facilities by the central bank.

However, the trend is now towards regulatory protection not only of the ordinary depositor, but of the corporate end-users of derivatives, who may be part of the "wholesale" rather than the "retail" market, yet still as vulnerable to mis-selling of complex products as individuals are to mis-selling of simpler products. In its agreement with Bankers Trust, the Federal Reserve Board said: "Banking institutions engaged in derivatives activities should maintain effective policies and procedures relating to client selection, sales practices, and pricing and valuation." (Laurie Morse, *Financial Times*, 8 Dec 1994)

The Barings Report

Much of the report by the Board of Banking Supervision was specific to a particular case, but the lessons derived are in some cases of wider significance. The lessons for management are obvious enough (14.2): understand the business fully, establish responsibilities clearly, segregate duties (the front and back office, for example), internal controls and independent risk management, significant weaknesses identified by audit committees to be rectified quickly.

Even if the Barings disaster could not have happened had Mr Leeson been subject to more effective management control, the report had numerous lessons for the Bank of England, designed to prevent a recurrence. Unless it is accepted that financial institutions should be unregulated, and subject only to the fullest disclosure requirements, on the New Zealand model, financial supervisors must be responsible for ensuring as far as possible that institutions under their control are adequately managed. They may not be able totally to prevent either fraud or folly, but they can try to reduce their occurrence, and most cases lie somewhere on the middle of the spectrum between the two.

The main lessons for the Bank of England may be summarized as follows:

— Better understanding of non-bank business of banks it supervises, including possibly joint action with other regulators (in this case the Securities and Futures Authority).

— Guidelines to Bank staff on how to investigate sources of profits and funding, and control systems, in risky areas, including more contact with local regulators.

— Understanding the management and control structures of banks under supervision, which should give advance notice of reorganizations and new operations.

— Better returns to the Bank about the business of groups as a whole, including profitability by product line.

— Higher level responsibility in each bank for the accuracy of returns to the Bank.

— More stringent conditions for solo consolidation of a bank with a securities subsidiary, such as Baring Brothers Limited with Baring Securities Limited, and better supervision of solo consolidated securities subsidiaries, if necessary with the help of the SFA.

— More contact between the Bank and internal audit committees.

— More on-site visits by Bank staff, but stopping short of regular inspections, which would need more staff and cost too much.

— Better information from accountants about banks' systems of control over the accuracy of information in returns.

— Tightening up of the guidelines on the overstepping of large exposure limits.

— Clarification of "letters of comfort" by banks in respect of the obligations of their subsidiaries. (Such letters appear to give a guarantee without actually giving one.)

— An independent quality assurance review of the Bank's supervision, which could challenger important decisions.

— Additional resources to be put into banking supervision.

— The Bank is to report on its implementation of these recommendations by 31 December 1995.

The Barings report is meant to deal with a specific case. Its general recommendations are of marginal significance, and involve essentially a tightening up of the existing system of supervision. It slams a number of stable doors after the horses have bolted. Its main thrust is to impel the Bank's supervision and surveillance department to get closer to the banks for which it is responsible, get better information from them, and question what they are doing more critically. It will be seen by many banks as an intrusion into their freedom to make decisions—and in some cases to make mistakes.

The question the report does not ask is whether it is appropriate for a securities firm, even if owned by and consolidated with a bank, to be supervised by Bank staff whose main experience may lie in the field of traditional banking supervision, or of areas of Bank activity, such as monetary policy, which are unconnected with supervision of any kind. The danger now is that Bank supervision staff will learn a lot more about international securities operations from the practitioners, but may still lack the credibility to teach them how to do their jobs better.

The question of the quality of Bank supervisory staff cannot be treated in isolation from the relatively recent reorganization of the Bank, or the question whether supervision should be given to a separate agency. The Bank has been divided into a monetary stability wing and a financial stability wing, with the latter responsible for supervision and surveillance. If staff are still to be transferred between the two wings, supervisors may not have a chance to make a career in supervision as a special subject. However, the existence of a separate supervision wing would make it easier to form from it a separate supervisory organization, under the Board of Banking Supervision, working in close contact with the Bank of England, whose main task would be monetary policy.[24]

This would avoid the risk of contagion between the Bank's supervisory reputation and its monetary reputation. It would avoid excessive concentration of powers in one centralized institution. This point has become more important since the Bank was given powers of co-decision with the Treasury on interest rates. To put it bluntly, if the Bank gets monetary policy wrong, its prestige as a supervisor is impaired. If it makes mistakes in supervision, its role as a monetary authority is affected.

This proposal would also separate the Bank of England's supervisory responsibility for rescuing institutions or letting them fail from its monetary function of lender of last resort. In the case of Barings, the systemic risk was not so great as to make it necessary to save Barings; but had the Bank as supervisor decided to save Barings, its role as monetary lender of last resort would have enabled it to do so without any independent decision on the desirability of such a move.

Concluding Comments

Derivatives are not intrinsically riskier than other financial products, but they can be used either to reduce risk or to increase it, at a lower cost than that of conventional products.

Derivatives are subject to the same kinds of risk as conventional products; credit, market, liquidity, settlement, operational, and legal. Capital requirements for the various risks should therefore be the same for derivatives as for other products, but the current exposure is harder to measure; the use of models may not help as much as is claimed.

Derivatives have developed so rapidly that the ability of managements and supervisors to keep up to date with the market has been stretched, sometimes to breaking point. Not enough has been done to bring unregulated derivatives traders into the net.

Derivatives of different kinds can be combined with each other and with conventional products to create webs of cross-claims so complex as to make it difficult to measure and manage risk.

Derivatives are of many different kinds with different risk and market characteristics. Interest rate derivatives are less risky than exchange rate, stock market or commodity derivatives, depending on the price volatility of the underlying assets. Swaps and forwards are sold over-the-counter, mostly by banks, while futures and options are traded on exchanges, and are thus more akin to securities products.

Both supervisors and bank managements need to be educated in the basics of derivatives. "Learning on the job" is not sufficient, and can be fatal. This is the only way out of the following dilemma: either the supervision and management of derivatives is left to amateurs, and risk not adequately controlled, or it is limited to professionals, and the market will be dominated by a handful of large firms, denying the genuine advantages of derivatives to a wider circle of users.

The regulation of securities-type derivatives, notably futures and options, is too important and too specialized to be left to banking supervisors. It should be carried out by qualified securities regulators or exchange regulators, whether in the home market or foreign markets. Banking supervisors should supervise only the general features of financial conglomerate groups centred around banks, while leaving the regulation of subsidiaries to the appropriate regulator.

Financial regulation needs to be functional as much as institutional, so that regulators can become sufficiently specialized in the complexities of products such as derivatives. There is a case for regulators corresponding to the functional divisions of trade associations, covering separately areas such as swaps, futures and options (combined), equities, and bonds.

[24] This course was advocated by the author in his memorandum to the Committee, "The role of the Bank of England", published in its report *The Role of the Bank of England* (HMSO: HC 98-II, 8 December 1993).

The Bank of England's supervisory functions should be hived off into a separate banking supervision agency which would be one among a number of specialized regulators, but also have special responsibility for banking and financial conglomerates.

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25 July 1995

APPENDIX 17

Memorandum submitted by Shell UK Ltd

INQUIRY INTO THE REGULATION OF DERIVATIVES

Shell UK is the operating company of the Royal Dutch/Shell Group in the UK. It is the second largest Shell operating company, accounting for roughly 10 per cent of the Group in financial and operational terms. Shell UK is engaged in three main businesses: the finding and production of oil and gas from UK offshore waters; the refining and countrywide marketing of oil products; and the manufacturing and marketing of petrochemicals.

Shell UK has a substantial oil trading activity in support of these businesses. We employ a team of 13 traders, and the value of crude oil and products traded on a typical day is of the order of £10m. The trading of oil related derivatives (see technical appendix for definitions of terms used in this submission) has become a significant aspect of the overall trading activity, adding value to Shell UK's operations in the pursuit of its business objectives.

For the purposes of the Committee's inquiry, we submit that trading in the form of derivatives does have a valuable role to play in the oil markets. It adds value through the facility to manage risk and uncertainty in a volatile commodity market where differences of timing between the incurring of liabilities and the realisation of the subsequent benefits can create substantial risk exposure. By the nature of oil markets, the parties to any oil trading activity are necessarily professional and experienced, and usually have substantial assets. At its best, regulation is light but effective in ensuring the commercial integrity of the market and its players. Heavy, tightly prescriptive regulation would stultify innovation and enterprise, adding unnecessary costs. In practice, it could drive such activity offshore since trading activities, using modern communications technology, are highly mobile. The added value from such activity could then be lost to the UK.

Internally, we have developed a control regime for our oil trading which complies with the regulatory framework, and is practicable, effective and yet conducive to the motivation and commercial enterprise of the traders.

Background

Prior to the oil price 'shocks' of the 1970s, much of the 'Free World's' production of crude oil, and the refining and marketing of oil products was carried out by large vertically integrated international oil companies—notably, the so called 'Seven Sisters'. Prices were relatively stable, being derived from the 'posted prices' for the crude oil, which were established in negotiation with the exporting governments. The trading of oil and oil products was limited largely to exchanges between the integrated oil companies seeking to derive mutual benefits in relation to the location, timing or quality of the oil in question.

The combination of the nationalisation of oil concessions in the main exporting countries, the subsequent oil price shocks of the 1970s, the rapid development of non-Opec oil production, eg North Sea oil, and the ensuing structural surpluses of capacity in the downstream sector of the industry, have transformed the structure of the international oil industry and have given the trading of crude oil and oil products a central role in the functioning of the industry.

Oil, both as crude oil and refined products, is by far the most traded commodity in the world. Today, the international oil industry comprises three distinct sectors, each separated by free open markets—the 'upstream' production of crude oil, the refining of crude oil into a variety of oil products, and the distribution and marketing of these products to end consumers.

In Europe, the 'Rotterdam' market in refined oil products is a major centre of trading activity, although the market no longer has a physical presence. It grew up on the basis of the exceptional concentration of refining capacity in the Rotterdam area and the inland supply of the refined oil products in Rhine barges. Likewise, the spot market which has developed since the start of North Sea oil production in the mid-1970s and, most notably the trading of Brent oil, has become one of the principal markers for oil pricing around the world.

Futures markets in oil developed slowly until 1984, when the New York Mercantile Exchange (NYMEX) attracted substantial interest with a market in West Texas Intermediate (WTI) crude futures. Subsequently the International Petroleum Exchange (IPE) in London created a market for futures in Brent crude. In 1994, the volume of Brent and WTI traded on the NYMEX and IPE exchanges was 155 million barrels/day, more than double total world oil demand. Growing awareness of the risks inherent in the oil markets gave rise to increased interest in risk management tools, and the consequent introduction of more sophisticated derivatives such as swaps and options.

Use of Derivatives in Shell UK

Shell UK's oil trading activity has the following objectives:

(1) to derive maximum value in the crude oil market for Shell UK's production of oil from fields on the UK Continental Shelf—today essentially the North Sea, although production from the West of Shetland venture with BP is imminent.

As a producer, Shell UK is predominantly concerned with trading which entails physical delivery of its equity oil from the North Sea. Derivatives are not used in this activity.

(2) To minimise the cost of procuring feedstock for Shell UK's two refineries, and related to this, the 'locking in' of processing margins.

In this area the choice for the trader between the use of various risk management tools is influenced by the nature of the business and the risks and uncertainties being managed. Derivatives are often standard in nature, but may also be devised freely to match the nature and pattern of the risk in question. Shell UK uses both standard and tailor-made forms of derivatives.

Refineries are better able to increase their narrow processing margins between the value of oil products and the cost of feedstock by matching their diet of crude oils to the processing capabilities of the refinery and the changing pattern of product prices in the market. If a suitable cargo of crude oil is purchased for a UK refinery in, say the Middle East, it will take a good many weeks for the oil to be landed, processed and sold as refined products. During this period, falling oil prices could turn a potential profit into loss. This time-related risk in volatile oil markets can be 'hedged' by selling oil through a derivative; as the notional re-purchase price of this position drops with the oil price, a trading profit is generated that will offset the fall in value of the cargo. Another use for hedging is in the management of the extra price risks associated with unusual levels of oil stocks; these may occur, for example, when product stocks are built up to cover refinery shutdowns for large-scale maintenance.

Such hedging has become particularly important in recent years with the structural oversupply of refining capacity putting severe competitive pressure on refining and marketing margins in Europe. Accordingly, the profit margins from refining and marketing are generally so small, in relation to the value of the underlying products, that minor price variations can destroy the margin in the time it takes to process a cargo of crude oil.

(3) To underwrite the risks of providing customers with fixed price contracts over a period against a background of volatile price movements.

Some industrial and business customers for oil products put greater value on the certainty of prices over the duration of the contract, than on the lowest possible average price. Their exposure to risk in volatile oil markets would either pose an unacceptable commercial risk or would require wasteful, and perhaps uncompetitive, contingencies to be made. Typical examples might be operators of air services for charter or those engaged in road construction. Oil companies using derivatives to manage the time-related risks of volatile oil markets can efficiently and competitively meet the requirements of such customers for fixed price contracts.

(4) To use our expertise and knowledge of oil markets to trade profitably by taking positions, unrelated to physical oil availability for our operations.

This aspect of the market, pure position trading, has an essential function in providing the liquidity for those wanting to use the market for hedging and the physical trade of oil. With sufficient expertise and knowledge of oil markets, it is a profitable activity in its own right, albeit not without risk and necessarily requiring an effective internal control regime.

Relationships Between Traders and Clients

The very flexibility of derivatives which makes them of particular interest to professional traders seeking to manage a diversity of time-related risks in volatile market conditions, inevitably entails a degree of complexity and exposure which is a danger to the inexperienced. Given this, and the high value of individual transactions, we take considerable care in the conduct of this business. Shell UK's trading counterparties are characterised as Market Counterparties or Ordinary Business Investors under the rules of the SFA (see below). They are oil market professionals, typically other oil companies or banks experienced and knowledgeable in this field. Any new counterparties are thoroughly vetted.

Shell UK does not act as an advisor, broker or agent on behalf of third parties, and does not trade with private individuals.

The Regulation of Derivatives Trading

The Financial Services Act 1986 regulates the conduct of 'investment business' in the UK. As its derivatives trading activities constitute investment business, Shell UK is a member of the designated self-regulating organisation, The Securities and Futures Authority Ltd (SFA). The SFA produces a Rulebook, the purpose of which is to ensure that members have a framework for compliance with the Act as it applies to their specialised area.

More specifically, Shell UK is an Oil Market Participant (OMP) member of the SFA, and as such, only a subset of the SFA Rulebook is applicable to its trading. At the inception of the regulatory regime for the oil markets, the Securities and Investment Board identified certain characteristics, including the absence of non-professional players and the strong *caveat emptor* ethos of the market, which led it to the conclusion that it was inappropriate to introduce the comprehensive regulatory regime that was needed elsewhere. The SFA, in the results of a survey of the oil markets in 1994, stated that the original reasons justifying the oil markets regulatory regime continue. This lighter regime is sufficient to ensure the requisite commercial integrity of the market and its participants, and continues, in our view, to be appropriate given that the underlying characteristics of the oil markets have not changed.

Additionally, heavier and more prescriptive regulation would have a stultifying effect, discouraging innovation and ingenuity in the management of risk and creating uncertainty in evolving markets. Trading activities of this sort, using modern communications technology, are highly mobile and not fixed by location. The added value from such activity, and the tax revenue, would be lost to the UK if heavy prescriptive regulation were to be introduced.

Risk Management Systems and Internal Controls

Recent, highly publicised cases where major companies have incurred crippling losses through the use of derivatives have resulted in part from lack of expertise, but in good measure from the failure to establish an effective and prudent control regime which prevents individuals from taking unacceptable risks and often concealing the degree of exposure.

From many years of experience in oil trading where the individual transactions are very large and the market risks are significant, Shell UK has developed—and continues to improve—the control regime for such trading activity. We believe that the measures taken in this regard exemplify best industry practice. In addition to clearly defined responsibilities and organisation for compliance with the regulatory requirements, they include:

— high standards of physical and electronic security;

— the separation of trading from the administration of payments for transactions;

— the supervision of all deals by a knowledgeable senior manager (with upward-only delegation of responsibilities in his absence);

— precisely defined position limits and limitations on the duration of contracts, and daily supervision of adherence to these;

— systems for instant assessment of the Company's exposure from all derivatives trading.

These measures are complemented by consistent pay and personnel policies including those covering, for example, drug and alcohol abuse. The trading activity is subject to regular internal audits. Preferred patterns of trading are recommended internally, and new patterns are regularly reviewed for improvements in the relationship between risk and return.

Summary

The trading of oil and oil products has developed as a consequence of major changes in the structure of the international oil industry, and now fulfils a key function. The previously integrated operations of the oil majors are now disaggregated and separated by open international markets for the trading of oil and oil products. These markets continue to evolve, and so do the instruments and transactions developed to manage risk and uncertainty.

There are evident dangers in the use of specialised, often innovative instruments such as derivatives. They are not suitable for the non-professional or inexperienced trader. However, with proper precautions and understanding, they have a valuable economic function, facilitating the continuing evolution of the oil industry and the efficient management of the related risks and uncertainties. The current light form of regulation is appropriate for this specialist trading activity, but it must be accompanied by effective internal management controls, regularly reviewed to meet the evolving challenges.

Technical Annex

A derivative is a generic term which is sometimes used loosely. In the context of this submission, a *derivative* is a futures contract, a contract for differences (swaps) or an option on either: each as defined in the Financial Services Act 1986[25].

A *futures* contract is a contract for the sale of a commodity under which delivery is to be made at a future date and at a price agreed when the contract is made. Oil futures contracts are made on an exchange, eg the IPE, which specifies standard terms for the contracts and guarantees their performance. Futures are traded in small standard parcels—for example, 1,000 barrels for a Brent crude future "lot". Under the rules of the exchange, a trader's position is with the exchange and the identity of the trading counterparty will remain unknown. The exchange also normally requires the posting of certain

[25] *Note:* There is uncertainty as to whether or not developed forward contracts constitute 'investments' falling within the definition of 'futures' in the Financial Services Act 1986. Shell UK Limited take the view that developed forward contracts are not futures and this submission should be read accordingly.

information about the traders, such as the value of securities held by the exchange against possible default.

A contract-for-difference or *swap* is an agreement where a variable price is exchanged for another variable price or for a fixed price over a specified period. It is an off-balance sheet financial arrangement which is settled by a transfer of cash. The agreement defines the volume, duration and fixed reference price. Differences are settled in cash for specific periods, monthly, quarterly or half-yearly.

An *option* is a contract that gives the right, but not the obligation, to buy or sell a future or a swap, at a certain price on or before an agreed date.

21 August 1995

APPENDIX 18

Letter from Securities and Investments Board (SIB)

EMPLOYEE INDEMNITY

In his evidence to the Committee on 18 July, Mr Blair undertook (Q 5732) to verify his belief that the Personal Investment Authority (PIA) has arrangements for employee indemnity similar to those provided by SIB to its employees.

SIB, PIA and FIMBRA all recognise that they have a duty at Common Law to indemnify or reimburse an employee against all expenses, losses and liabilities incurred by him in the execution of his employer's instructions, or within the authority granted to him by his employer, or during the reasonable performance of his duties. All three have in place arrangements to meet this obligation.

The indemnity to SIB staff is set out in its Staff Handbook and thus forms part of the conditions of employment for staff. This provides that SIB will indemnify employees against any liability they incur in connection with claims or proceedings against them, including any costs reasonably incurred in defending them, whether or not judgement is given in their favour. This indemnity does not extend to liabilities arising from employees acting in bad faith or from activities clearly outside or inconsistent with an employee's responsibilities. It is also subject to the employee concerned liaising closely with SIB about the course of any proceedings, and to not incurring costs on a basis contrary to SIB's wishes.

PIA and FIMBRA do not refer to their indemnity arrangements in their Staff Handbook, but they have both confirmed that their practices are effectively the same as SIB's, both in the extent of the indemnity provided and in the provisos attached to it. PIA and FIMBRA have taken out professional indemnity insurance to help ensure that funds are available to meet obligations they may incur by way of indemnity or otherwise without the need for an additional levy on their members. The level of cover is designed to enable any likely obligations to be met, but both PIA and FIMBRA have confirmed that it does not modify the primary obligation, or set a limit on the indemnity given to an employee should the cost of the indemnity exceed the level of cover.

Thus, each of the three regulatory bodies provides effectively the same indemnity to its employees.

31 August 1995

APPENDIX 19

Memorandum submitted by the Securities and Investments Board (SIB)

THE DISCLOSURE OF REGULATORY INFORMATION BY THE SECURITIES AND INVESTMENTS BOARD (SIB)
LEGAL AND POLICY CONSIDERATIONS

INTRODUCTION AND SUMMARY

1. The purpose of this note is to explain SIB's understanding of the law[1] affecting its ability to disclose information which it acquires in the course of carrying out its work, and to outline the policy considerations which it bears in mind in exercising its limited discretion whether to disclose such information.

[1] This note describes the legal position in England and Wales; the position in Scotland and Northern Ireland differs in certain respects.

SIB's position in these matters is similar in general terms to that of many other financial services regulators and supervisors; SIB has therefore liaised with them in preparing this note. However, since there are differences of detail in the position of the various bodies, this paper does not attempt to be a comprehensive guide to the position of all regulators in this area.

2. In particular, this note:

— explains SIB's position under the Financial Services Act 1986 ('FSA') (paragraph 3);

— outlines policy reasons why regulators and supervisors should deal on a confidential basis with information which they receive in the course of their work (paragraphs 4–9);

— notes how this confidentiality can frustrate the public's expectation that they will be told what regulators discover or do in particular cases (paragraph 10);

— summarises the effect of section 179 of the FSA, which makes it a criminal offence to disclose restricted information (paragraphs 15–18);

— describes the system of 'gateways' under s 179 which permits SIB to disclose information for specific purposes, and gives some examples (paragraphs 19–22);

— notes that SIB has not been able to identify any specific statutory function in the discharge of which it would be enabled or assisted by acceding to a Parliamentary Select Committee's requests for disclosure of restricted information (paragraph 23);

— lists the FSA powers which do enable SIB to publish information, views, advice or reports, and relates these to the s 179 restriction (paragraphs 25–28);

— outlines the effect of the Investment Services Directive, to be implemented by 1 January 1996, on these disclosure provisions (paragraphs 29 and 30);

— summarises the general law affecting disclosure (paragraphs 31–40); and

— lists the ways in which SIB and other FSA regulators seek to publicise and report on their activities, to the extent permitted by the law (paragraphs 41–44).

SIB: ITS BACKGROUND AND FUNCTIONS

3. SIB was incorporated in 1985 (when the Bill for the FSA was in preparation) as a private company limited by guarantee, in anticipation of becoming the main regulatory and enforcement body under the FSA. Its objects (as set out in its Memorandum of Association) include carrying out any functions transferred to it under section 114 of the FSA. Under the initial delegation order of 18 May 1987, and a number of subsequent delegation orders, there have been delegated to SIB most of the administrative and legislative functions ascribed in the FSA to the Secretary of State; these include authorisation, monitoring, investigation, enforcement and prosecution functions. By the Transfer of Functions (Financial Services) Order of 7 June 1992, most of the Secretary of State's functions under the FSA were transferred to the Treasury, including the functions of resuming (or assuming) functions from SIB. SIB now therefore relates to Government through the Treasury.

CONFIDENTIALITY—RATIONALE AND EFFECTS

4. In order to operate effectively, financial services regulators and supervisors must have access to a wide range of information. They need this on an ongoing basis—not just to investigate to find out what has happened when something goes wrong, as the DTI might seek to do using Companies Act powers, or with a view to possible criminal proceedings, as the SFO might do in using its powers. FSA regulation is designed to reduce the risk of things going wrong in the first place; information is therefore needed for proactive as well as reactive regulatory action—for example, to vet those who seek authorisation to carry on business, to monitor the compliance of those who are authorised, to judge when intervention is necessary to protect investors, and to determine when disciplinary action is warranted and whether to bring actions for redress.

5. Those who wish to carry on investment business in the UK generally need authorisation under the FSA to do so. With that authorisation comes a duty on firms to supply regulators with the information which they need to do their work—in particular, to satisfy themselves that authorised persons are carrying on their business in compliance with regulatory requirements. This duty is an onerous one: those who wish to do business with investors must accept significant inroads into their commercial and personal privacy. At the same time, regulators are rightly expected not to abuse this privileged access to confidential information. This is reflected in an obligation, imposed on some regulators by common law, and on others, including SIB, by statute, not to disclose information which they obtain, except in particular circumstances.

6. Information supplied to regulators will often be sensitive, for a variety of reasons. Information provided by firms about their own affairs, such as their business plans, fees, and finances is commercially

sensitive. Disclosure by regulators, which might result in the information becoming public, would be likely to put the firm at a competitive disadvantage. In some cases, the information in question might be 'inside information', the disclosure of which could amount to an insider dealing offence under the Criminal Justice Act 1993. In other cases, information of regulatory significance may be personally sensitive, for example information on the personal affairs of individuals holding a significant interest in authorised firms.

7. Regulators also obtain information from firms about their clients, including about their personal and financial circumstances. It is obviously important that an investor gives full relevant personal details to the firm from whom he seeks investment advice, otherwise inappropriate advice may be given. The common law of confidentiality will apply in these circumstances: the investor is entitled to expect that the information will not be divulged by the firm without his agreement, except where this is necessary for the purpose of complying with regulatory requirements, for example.

8. Regulators do not rely merely on regulated firms for the information they need in order to regulate effectively. Information is obtained from a variety of sources—other regulators, here and abroad, investors themselves, members of Parliament, journalists, other law enforcement authorities, such as the police and the Serious Fraud Office, and informants—such as employees of regulated firms—who may wish to remain anonymous. Some of these sources are under a duty to co-operate in some circumstances; others are not. Quite apart from any legal duty, it is in a regulator's interest to make very careful and responsible use of information obtained from third parties, if important sources of regulatory information are to remain productive.

9. Parliament has required statutory financial services regulators not to disclose the information they have, except in particular circumstances. This has the effect of respecting the position of those from whom the information is obtained—whether regulated firms or third parties who volunteer information about them—and of securing the free flow of timely information to regulators. Recognising, however, that regulators need to disclose information in fulfilling their own functions, to liaise with each other to do an effective job, and that there is a public interest in some non-regulatory authorities having access to regulatory information, Parliament has also put in place a number of exceptions to the rule that information cannot be disclosed. These are commonly called "gateways" and are described more fully in paragraphs 19ff below. But the statutory restrictions on disclosure specific to a particular regulated sector are not the only considerations relevant to a regulator's ability to disclose. Other relevant factors are considered in paragraphs 31–39 below.

10. The underlying obligation on regulators not to disclose the information they have inevitably conflicts with the understandable public expectation that investors and others should be entitled to know what regulators, particularly statutory regulators, are doing, and why. This expectation increases where there are complaints about a regulated firm, and is at its keenest when there is a publicly visible 'scandal', with significant amounts of money at stake, when there is a clear public interest in finding out what went wrong. There is also an expectation, especially on the part of those who have lost money or other assets, that 'someone in authority' will provide a definitive account of what happened and who was responsible. There is often frustration when no such statement is made; the authorities may even appear, by their silence, to imply that no harm was done, and that investors' complaints were misplaced.

11. Some regulators have extensive powers to seek redress for victims of regulatory misconduct—for example, under section 61 of the FSA. It would be unhelpful if regulators were expected—even where the law did not prohibit them from doing so—to explain their actions in public while cases are still progressing (whether through the courts or by negotiation). This would often require them to expose their own thinking, and any legal advice they had received on the strengths and weaknesses of their case; this would put them at a serious disadvantage, since their opponents are not obliged to do the same. After the event, it might be possible to describe a case fully without damaging other cases being pursued under the same powers. However, where the underlying factual or legal position was common to the finished case and the continuing ones, to discuss the former openly could well jeopardise the regulator's negotiating position on the latter, by exposing doubts about the strength of the regulator's arguments in the continuing cases.

12. In addition, it is often a condition of settlements negotiated between a regulator and a firm that publicity of the outcome is limited. SIB has sometimes accepted such a condition where this has appeared on balance to be in the interests of investors—for example, in the proceedings brought by SIB against Melton Medes Pension Trustees Ltd and others, which were settled earlier this year. In such cases, it will normally be difficult to satisfy enquirers that the regulator has settled on terms which are in the interests of those concerned. The Judge in the Melton Medes case, Mr Justice Robert Walker, took the unusual step of saying of SIB's role in the case and in the eventual settlement: "Regulatory Bodies are the guardians of the public interest and they are expected to get results. In this case, jointly with the plaintiffs in the main action, they have got results, but it is not necessarily in the public interest in what is essentially civil litigation to press claims to extreme lengths. The question of when an acceptable compromise is offered is one which involves very difficult judgements and it seems to me that those difficult

judgements have been correctly made in this case". Those comments were obviously welcome to SIB, and no doubt offered assurance to those who wondered whether SIB had reached a good settlement. SIB cannot always, however, expect express judicial comment on the merits of its approach.

13. The statutory prohibition on disclosure can be as frustrating for regulators as it is for those who seek information from them. The duty can prevent regulators from explaining in any detail what happened in a particular case, where such publicity could have a deterrent effect on future misconduct or could help inform debate on better policies, rules, and laws for the future. This prohibition can also prevent regulators from publicising their successes.

14. The rest of this paper explains the legal position in greater detail and, against that background, considers whether there is more that SIB can do to assist the public in understanding its role and work.

DISCLOSURE OF INFORMATION AND THE FSA—THE DETAILED POSITION

15. The main confidentiality obligation to which SIB is subject is set out in section 179 of the FSA, entitled "Restrictions on disclosure of information". Under this section neither SIB nor its officers and servants may disclose information about any person's affairs where it has obtained the information for the purposes of, or in the discharge of, SIB's functions. Breach of section 179 is a criminal offence of strict liability. It is no defence to establish that the disclosure believed on reasonable grounds that the disclosure was lawful.

16. SIB is included in section 179 as a "primary recipient". All information relating to the business or other affairs of other persons which SIB obtains in the course of its work is therefore restricted, unless it has been disclosed to the public in circumstances or for a purpose not precluded by section 179. Other "primary recipients" include the Treasury, the Secretary of State, the Bank of England, the Director General of Fair Trading, the Friendly Societies Commission, any member of the Financial Services Tribunal and the Investors Compensation Scheme Ltd (ICS). Where primary recipients obtain restricted information in the course of their FSA work, that information is subject to the prohibition on disclosure in section 179. Not all FSA regulators are primary recipients for the purposes of section 179. As the Act stands at present, the self-regulating organisations (SROs) and recognised professional bodies are subject to the section 179 prohibition only in respect of information which they receive (whether directly or indirectly) from SIB or one of the other primary recipients. Such organisations are, however, subject to many of the other legal restrictions dealt with later in this note.

17. Section 179 restricts the disclosure of information and not of opinions per se. In the case of *Melton Medes* v *SIB*, Mr Justice Lightman accepted that the expression by SIB of its own view could not, of itself, amount to "disclosure" in breach of section 179, though it would be a question of fact whether, in expressing its view, it also disclosed restricted information. SIB also needs to take care, in expressing views, that it does so within the proper exercise of its functions under the FSA.

18. Section 179 does not prohibit SIB from disclosing information where it obtains the consent of each person to whom the information relates and, if different, the person who provided the information. Nor does it preclude the disclosure of information if it is or has been made available to the public from other sources.

THE GATEWAYS

19. In addition, section 180 sets out a number of detailed circumstances in which the prohibition in section 179 does not apply. These "gateways" are largely purposive in nature—that is, they allow disclosure to certain persons where this is intended for a specified purpose. In the circumstances specified, SIB has a discretion (rather than a duty) to disclose restricted information. That discretion has to be exercised in accordance with established principles of public law.

20. Some of the gateways more frequently used by SIB include:

— for the purpose of enabling or assisting other regulators (the Bank of England, the Building Societies Commission, the Friendly Societies Commission, DTI Insurance Division, the SROs etc) to carry out their functions as such;

— with a view to the institution of or otherwise for the purposes of criminal proceedings;

— with a view to the institution of or otherwise for the purpose of civil proceedings arising under or by virtue of the FSA;

— for the purpose of enabling or assisting SIB to discharge its functions;

— for the purpose of enabling or assisting ICS to discharge its functions;

— to the Treasury or the Secretary of State in the interests of investors or in the public interest.

21. Where any of the gateways in section 180 is used, those receiving the information directly or indirectly from SIB are themselves bound by the provisions of section 179. However, disclosing information under a gateway may result in that information losing its restricted quality. For example, the disclosure of information in civil proceedings under the FSA may lead to evidence being given or read out in open court or judgement being handed down which includes what was restricted information. Once the evidence or judgement is publicly available, the information is no longer restricted. By publicising more generally judgements and evidence given or read out in open court, SIB has been able to ensure that the public is informed as much as possible about its litigation work. In 1994/95, for example, SIB issued press releases publicising 14 injunctions and three s72 winding-up orders granted by the courts.

22. The FSA provides that the Treasury may make an order to add an extra gateway to the list in s180 to enable or assist a "public or other authority" to discharge specified functions. The Treasury has made several such orders, and gateways have been opened to authorities such as the Panel on Takeovers and Mergers.

23. There is no express gateway to Parliament or to any Select Committee. There is one particular gateway—s180(1)(e)(i)—which permits disclosure to enable or assist SIB to discharge its functions. SIB has considered whether it could use this gateway to disclose restricted information to a Parliamentary Select Committee. A decision by SIB itself to use the gateway requires particular care, and a close regard to the discharge of specific functions. SIB has not been able to identify any specific statutory function in the discharge of which it would be enabled or assisted by acceding to Select Committees' requests for disclosure of information, for example, of the draft document supplied to SIB by FIMBRA in the Summer of 1994.

24. Nothing in the FSA makes it lawful to disclose information once the case is over, where it would have been unlawful to disclose it while the case was in progress, though SIB might choose to exercise any relevant discretion differently on the conclusion of a case. As noted above, when an enforcement case is closed, information may be available to the public as a result of court proceedings.

FSA POWERS AFFECTING THE ABILITY TO PUBLISH INFORMATION, VIEWS, ADVICE, REPORTS OF INVESTIGATIONS

25. The FSA contains various other powers and restrictions which apply to SIB in publishing and disclosing information, advice and views. For example, section 102 requires SIB to keep a register which includes details of authorised persons and entries in respect of persons disqualified under section 59 from being employed in connection with investment business. By virtue of section 103, the register is to be open to public inspection, save in respect of the entries about disqualified individuals. These entries can be inspected only in limited circumstances—where the person asking to inspect specifies a name about which there is such an entry, or satisfies SIB that he has a good reason for seeking the information. This limits SIB's ability effectively to publicise the work it does in banning unfit individuals from being employed in connection with investment business.

26. As a body exercising public functions, SIB is subject to the basic administrative law duty to act fairly. In addition, the FSA incorporates procedural safeguards in the interests of fairness to firms and individuals against whom SIB may take action. For example, under section 60 SIB may issue public statements of misconduct, but only about a limited class of authorised person—mainly firms directly regulated by SIB. Where SIB is minded to issue such a statement, the FSA requires that it must first give notice to those to be criticised in the statement, who may refer the case to the Financial Services Tribunal. There may then be a hearing before the Tribunal, before any determination whether to confirm SIB's decision to publish. Due process inevitably takes time. There may well be a period of months between a decision to publish a statement of misconduct and its eventual publication. In the intervening period, it would be quite inappropriate for SIB to make critical statements which effectively pre-judged the issues. SIB has a discretion under section 101(2) of the FSA to publish the reports of the Tribunal (whether arising from the exercise of s60 or otherwise) and to offer copies of such reports for sale. SIB's practice has always been to publish such reports.

27. SIB is sometimes asked to publish reports of its investigations—comparisons are drawn with the publication by the Secretary of State of reports by DTI inspectors appointed under section 432 of the Companies Act 1985. SIB has no specific power to publish reports of its investigations.

28. SIB is also empowered by section 206 of the FSA to publish information or give advice about the way the FSA operates, about SIB's functions, and other matters for the protection of investors. SIB frequently issues guidance under this section. The power does not allow SIB to disclose restricted information—see section 206(3).

THE EFFECT OF EUROPEAN COMMUNITY DIRECTIVES

29. European Community Directives relevant to the regulation of financial services take a similar approach to that found in the FSA. The Investment Services Directive (ISD), which must be implemented in all member states by 1 January 1996, requires that "Member States shall provide that all per-

sons who work or who have worked for the competent authorities, as well as auditors and experts instructed by the competent authorities, shall be bound by the obligation of professional secrecy. Accordingly no confidential information which they may receive in the course of their duties may be divulged to any person or authority whatsoever, save in summary or aggregate form such that individual investment firms cannot be identified".

30. It is anticipated that SIB and the SROs will all be competent authorities for the purposes of the Directive. When implemented, this is expected to have the same substantive effect as if the SROs as well as SIB were primary recipients under section 179 in respect of information which they obtain about ISD firms. The Directive envisages exceptions to the general rule, to allow co-operation between home and host state regulators, for example, but the gateways are more restrictive than those in the FSA at present; as a result, some of the FSA's gateways will need to be closed on implementation of the ISD.

General law affecting disclosure

31. Apart from its special position under the FSA, SIB needs to observe the general law relevant to disclosing information. Some of this works in favour of disclosure, some against.

32. To take an example, SIB will often receive information from other regulators who are themselves subject to restrictions on disclosure. In the case of information received from the Bank of England, SIB will be bound not only by FSA restrictions but also by those in the Banking Act 1987. This will commonly mean that SIB cannot disclose the information obtained from the Bank without the Bank's consent.

33. Those who hold personal data about individuals on computer are obliged, under the Data Protection Act 1984, to let those individuals know, on request, what that information is. SIB is subject to this obligation, unless access would be likely to prejudice the proper discharge of those of SIB's functions specified in an order made under section 30 of that Act. Where SIB holds personal data about individuals on computer, it is obliged not to disclose the data to third parties except in the circumstances permitted by sections 28 and 34 of that Act (eg where the information is required for the apprehension or prosecution of offenders) unless that third party is registered with the Data Protection Registrar as a person to whom SIB may disclose information.

34. SIB is also under a duty to disclose information by virtue of the Money Laundering Regulations 1993. The Regulations impose specific duties on supervisory authorities (including SIB and the SROs). Under regulation 16, where SIB (or any other identified supervisory authority) obtains information which, in its opinion, indicates that any person has or may have been engaged in money laundering, it must, as soon as reasonably practicable, disclose that information to the police. The obligation overrides any restrictions contained in section 179 of the FSA, any other statutory provision or in the common law.

35. Under the common law of contempt of court and the Contempt of Court Act 1981, SIB may not publish to the public at large, or to a section of the public, information which is intended to or is likely to interfere with or obstruct the fair administration of justice. In practice, this means that SIB may be restricted in the information which it can publish if the matters to which that information relates are the subject of active criminal or civil proceedings. In particular, any publication made by SIB which prejudges any issues in pending proceedings may be a criminal contempt, punishable by an unlimited fine and/or term of imprisonment.

36. SIB is also subject to the provisions of the Rehabilitation of Offenders Act 1974 (ROA 1974). The FSA expressly permits regulators to obtain, and regulated persons to disclose, details of spent convictions in certain circumstances, and certain regulatory proceedings are also exempted from ROA 1974. However, SIB and other financial services regulators are prohibited from disclosing information contained in their records concerning spent convictions of any person unless the disclosure is made in the course of their or their employees' "official duties" (section 9 of ROA 1974). A disclosure in breach of ROA 1974 is a criminal offence.

37. Restrictions on disclosure may stem from common law principles rather than statute. The fast-evolving law on public interest immunity is an example here. As the House of Lords made clear in *R* v *Chief Constable of the West Midlands Police ex parte Wiley* last year, there may be times when it is inappropriate to disclose information for the purpose of court proceedings when to do so might be contrary to the public interest, without asking a Court to balance that interest against the public interest in the administration of justice.

38. Confidentiality may arise by agreement between a regulator and a third party. So, for example, SIB may agree a Memorandum of Understanding with an overseas regulator which circumscribes SIB's freedom to disclose even when there is otherwise a gateway. Whilst SIB cannot fetter its discretion to disclose information, it would expect to honour its agreements under MoUs except in the most exceptional

circumstances. The importance of effective international co-operation in a global investment market cannot be overestimated.

39. Some regulators, such as the SROs and some of the recognised investment exchanges, are bound by agreements with their members to keep information confidential, rather than by statutory duties. Breach of the agreement in that respect could leave them exposed to an action for breach of contract, rather than prosecution.

40. Regulators are often in receipt of witness summonses, requiring them to give evidence in civil or criminal proceedings. SIB has a gateway to disclose information only in those civil proceedings which arise under or by virtue of the FSA or are before the Financial Services Tribunal. Section 180(1)(a) of the FSA permits SIB to disclose information with a view to the institution of or otherwise for the purposes of any criminal proceedings. Furthermore, SIB is under a positive duty, when it acts as a prosecutor, to disclose information in criminal proceedings. It is then in no different position from any other prosecutor.

AGAINST THIS BACKGROUND, WHAT DOES SIB DO TO PUBLISH INFORMATION ABOUT ITS ACTIVITIES?

41. Under section 117 of the FSA, SIB is required to make a report to the Treasury at least once a year on the discharge of the functions transferred to it by delegation orders and on such other matters as the delegation orders may require. The Treasury is required to lay any such report before Parliament.

42. SIB's Annual Reports give a full account of its activities over the year, including in the enforcement area. In addition, as indicated in paragraphs 25–28 above, SIB publishes information and advice on various matters relating to the protection of investors, and makes known, to the extent permitted by law, details of disqualification directions which it has made under section 59, and statements of misconduct under section 60.

43. Of the approximately 23,000 firms authorised under the FSA, only a very small number are directly regulated by SIB. The great majority are regulated by SROs and Recognised Professional Bodies, and are therefore subject, in appropriate cases, to disciplinary action by them rather than by SIB. In such cases publicity of the outcome of the proceedings is a matter for the Recognised Body concerned. By way of example, the Securities and Futures Authority published the outcome of 46 disciplinary cases in its last financial year.

44. SIB has considered whether it could routinely do more to explain how it goes about its work, and how it has dealt with particular cases. As to the former, there may be value in imposing on SIB an obligation, with which it would be happy to comply, to provide a copy to the Treasury of its management plan and budget for the coming year, not just its Annual Report on the past year, with a corresponding obligation on the Treasury to lay these before Parliament. As to particular cases, there will continue to be a significant limit—for the reasons set out earlier in this note—on what SIB can say about enforcement work, even after the event. SIB will, however, continue to publicise details of its enforcement work wherever the law allows, unless this would be likely to be contrary to the interests of investors. In particular, SIB will account for its enforcement efforts as fully as it can in its Annual Report.

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