

Briefing Note:

Effective supervision before more regulation

The current crisis in the banking industry has inevitably led to calls for more regulation to improve the internal and external supervision of the industry. Yet the fact remains that the current legal and regulatory regime already provides for the very supervision that is being called for. This briefing note aims to illustrate the fact that there is no need for additional legislation or regulation on this matter. What is needed is not more legislation and regulation. What is needed is the political will and courage to enforce what exists already.

Supervision has always been a duty

The on-going banking crisis has highlighted the woeful level of supervision that took place, both within the industry players and of them. Regardless of whether or not senior management were aware of or understood the risks being run by their organizations, the result of the lack of effective supervision is all too self-evident in the damage currently being wrought in the wider market. This has led to the inevitable calls from politicians, the media, and the tax payer and, in some cases, even from the banking industry itself, for more regulation to prevent this from happening again.

Yet these calls ignore one inescapable and inconvenient fact. The current legal and regulatory framework already requires senior management to undertake the level of supervision now being called for, and it already gives the regulators sufficient powers to supervise the industry players and enforce that requirement. In terms of the failure of supervision, what has happened is not so much the failure of regulation as the lack of any will on the part of the political establishment, the regulators, the industry, and indeed the shareholders to follow and enforce the very framework that they now criticise.

Has self-regulation been a failure?

In the Senior Management Arrangements, Systems and Controls Sourcebook (SYSC), a component of the FSA Handbook, the Financial Services Authority (FSA) makes it clear that it is the senior management within regulated organizations who have the primary responsibility for enforcing the regulatory regime within those organizations. Given the FSA's oft repeated stance that it does not see itself as an enforcement agency, it unwittingly encouraged senior management to develop the perception that they faced little, if any, real risk of meaningful sanctions for failing to satisfy their supervisory obligations. Effectively they were left to regulate themselves and their organizations. The current crisis is evidence

Points to note:

- 1 The current failures are not due to the lack of regulation, or even the sufficiency of regulation. They are due to a lack of enforcement of the current legal and regulatory obligations
- 2 The current legal and regulatory framework provides the necessary tools for regulators to enforce the existing supervisory and risk management obligations
- 3 Calls to create new or additional regulations to provide for the internal and external supervision of financial service organizations are premature

SYSC Rule 4.3.1 states '[a] common platform firm, when allocating functions internally, must ensure that senior personnel and, where appropriate, the supervisory function, are responsible for ensuring that the firm complies with its obligations under the regulatory system. In particular, senior personnel and, where appropriate, the supervisory function must assess and periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the firm's obligations under the regulatory system and take appropriate measures to address any deficiencies.

enough of the bankrupt nature of this approach: senior management were either unable or unwilling to meet their supervisory obligations in a meaningful manner.

Supervision and risk control

The inability of senior management to recognise the significance of the risk to which their organizations were exposed does not sit with the requirements of the existing framework. Chapter 7 of SYSC makes it very clear that senior management within regulated organizations must approve and periodically review their organizations' risk management strategies and exposures. Indeed SYSC goes further and requires that organizations monitor the adequacy and effectiveness of their risk management procedures and, where required, of the measures they have taken to remedy any identified deficiencies.

The tools and powers required by regulators to monitor and supervise organizations' conformance to their obligations have always been available. The FSA Handbook makes it clear that regulated financial service organizations are required to retain sufficient records to allow any relevant competent authority to monitor their compliance with their regulatory obligations, and that it is the responsibility of senior management to ensure that they keep those records.

Legislation also plays its part. Both the Financial Services and Markets Act 2000 and the Companies Act 2006 require organizations to keep various records. In some cases these records are specified directly. In other cases the Acts require organizations to determine the records they need to retain in order to satisfy a defined purpose. What is clear is that they must keep records, as it is these records that the regulators will use to monitor organizations' compliance with their legal and regulatory obligations.

Approved persons

Quite aside from organizations' record retention obligations, the regulators have access to yet a further tool to enable them to supervise regulated organizations. In any regulated financial service organization, individuals who perform certain 'controlled functions', must be approved to do so by the FSA before they can perform those functions.

Yet the very failure of financial service organizations to enforce the regulatory regime within their organizations, the failure to implement effective risk management strategies and processes, was the responsibility of individuals who were approved persons.

The risk management and risk control responsibilities are encapsulated by the overall general organizational requirements set out in chapter 4 of SYSC.

SYSC Rule 3.2.20(1) states that '[a] firm must take reasonable care to make and retain adequate records of matters and dealings (including accounting records) which are the subject of requirements and standards under the regulatory system.'

For a more detailed discussion of some of the document and record retention obligations, see the briefing note entitled *Record retention and information governance*. Kalypton Limited. 2008.

The Supervision Sourcebook (SUP) sets out a detailed list of these 'controlled functions', which include director functions, non-executive director functions, chief executive functions, systems and controls functions, and significant management functions.

The Fit and Proper Test for Approved Persons Sourcebook (FIT) the FSA makes it clear that one of the assessment criteria for approved persons is their competence and capability in relation to the controlled function that they intend to perform.

Can regulation be made to work?

The FSA's light-touch regulatory regime is rightly recognised as business friendly. It strikes the difficult balance of regulating an industry and yet providing the flexibility to allow that industry to grow and develop as the regulated organizations see fit. The obligation on those organizations is that they have to conform to the principles of the regime.

The regime rightly places the primary duty of enforcement on the shoulders of the senior management in regulated organizations. It is their responsibility to ensure that their organizations conform to their lawful regulatory obligations. It is their responsibility to police their organizations. It is here that the FSA should enforce the regulatory obligations. If the FSA fails to change the perception of senior management that they face no personal sanctions for failing to satisfy their duties then no regulatory regime will work, regardless of whether it is light-touch or heavily prescriptive. Senior management will only take meaningful steps to satisfy their organizations' obligations if they appreciate that they will face meaningful sanctions, including personal sanctions, if they fail to do so.

The regulators must learn to ask searching questions and to demand that the answers be given in plain simple language. This is not because the investigator may or may not understand what is being said, but because it must make sure that the responder understands what it is they are saying. It is easy to hide ignorance or confusion in jargon-laden language. It is far harder to do so in plain language.

General duties and obligations

The failure of regulators to enforce the existing legal and regulatory framework does not excuse the similar failure of shareholders to hold directors to account for their failings. Nor does it excuse those very same directors of their failure to meet those same duties.

If there had been any doubts over whether or not directors owed a duty to their company to take into account the long term consequences of their decisions, then these have been dispelled by section 172(1)(a) of the Companies Act 2006. This duty, as with all others, is subject to the requirement for a director to act in good faith and to exercise reasonable care, skill and diligence.

It would be a mistake to imagine that the use of the words 'reasonable care, skill and diligence' implies a level of care that is minimal, that merely paying lip service to the duty will be sufficient. Section 174 elaborates further on the duty. Subsection 2(a) makes it clear that the 'care skill and diligence' expected would be that exercised by a person with 'the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company', and under subsection 2(b), 'the general knowledge, skill and experience that the director has.'

A director of a regulated financial service organization would, as an 'approved person', be expected to have a higher standard of 'general knowledge and skill' than might otherwise be the case.

In force since 1 October 2007, section 172, which is entitled 'Duty to promote the success of the company', sets out a list, albeit incomplete, of a director's duties towards his or her company.

The explanatory notes to the Companies Act 2006 make it clear that 'the duty does not require a director to do more than good faith and the duty to exercise reasonable care, skill and diligence would require'. The note explains further that a director would not be held liable for a process failure which would not have affected his decision as to which course of action would best promote the success of the company. The director would not be protected from liability for a process failure that would have affected his decision. Arguably, the failure to ensure that the supervisory and risk management processes were effective is just such a failure.

Failure or suspension

The banking crisis has given rise to claims that it is evidence of the failure of capitalism. This is hyperbole. The rule of law, and the objective enforcement of that law is a fundamental component of capitalism. What has occurred over the past decade is a collective failure of will to implement existing regulation in a meaningful way. It is as if the rule of law within a particular industry has been suspended for an extended period of time, a period where the lack of supervision has allowed the development of the excesses that have led to the current crisis. It would be wrong to claim that capitalism has failed. It might be more accurate to say that capitalism, in its true sense, had been suspended.

For a useful discussion of the importance of legal frameworks for the development and operation of capitalism see Hernando de Soto, *The Mystery of Capital*. Bantam Press. September 2000. ISBN 0593046641.

Conclusion

The current legal and regulatory framework provides sufficient powers and guidance for all parties to have understood, implemented, and, where necessary, enforced the existing supervisory obligations of senior management. That they have failed to do so is an indictment not of the supposed insufficiency of the existing framework. It is an indictment of the collective failure of the parties to find the will to abide by that framework.

It is pointless to call for yet more regulation unless there is also demonstrably the will to implement and enforce that regulation in a meaningful manner. Simply producing endless reworking or revisions of existing regulations will achieve nothing without the attendant enforcement, as without that essential step such regulations will simply be ignored by all concerned. It would be far better to use the framework that currently exists and to enforce it meaningfully. Only then will any real gaps become apparent, and only then will it be possible to produce new, effective regulations.

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