Cutting a Path through the Regulatory Jungle

by Adrian Coles

INTRODUCTION

Regulation is a key feature of the financial services industry. Few institutions can conduct themselves as they wish but, rather, must take account of a host of major and minor regulations issued by a variety of agencies. This article uses the British building society industry to examine the components of the regulatory process, paying particular attention to the differences between regulation, supervision and enforcement, and to the two main purposes of regulatory activity - to underpin the prudential health of an organisation and to influence the way in which it conducts its relationship with its customers. The paper is concluded with a brief examination of the differences between national and international regulation, a summary of the UK Government's deregulation initiative, and an analysis of one of the major regulatory questions in the UK - how to facilitate the transfer of the business of a mutual organisation to an institution which has stock, or equity based, status.

REGULATION, SUPERVISION AND ENFORCEMENT

Much current building society regulation is based on legislation, but is not to be found in the Building Societies Act 1986 itself.

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This legislation gives the authorities the power to "flesh out" the broad legislative principles by introducing orders and regulations that are known as "Statutory Instruments". These generally are passed by the House of Commons without debate. (Many are enacted through what is called the "negative resolution procedure" and become law unless a vote is organised which results in a majority of Members of Parliament expressing their opposition to the measure. In some more important cases a positive vote to enable the measure to go through is required.) Beneath this the Building Societies Commission, the building societies' prudential supervisor, issues what are known as "Prudential Notes". The purpose of Prudential Notes is to set out and explain what, in the opinion of the Commission, is needed for a building society to meet the statutory criteria of prudent management, and to give guidance to building societies on important aspects of their business. Prudential Notes have covered such areas as capital adequacy, liquidity, funding and systems. For matters without prudential impact, and of lesser importance, the Commission issues what are termed "Guidance Notes" and for matters of generally lesser importance there are "Dear Chief Executive" letters. Each successive tier of regulation broadly covers matters of lesser importance and greater detail.

The second element of the process is supervision. That is the process which a particular agency, be it the Bank of England which supervises the banking sector, or the Building Societies Commission, goes through in order to assess whether the institutions for which it is responsible are actually adhering to the regulations. The more detailed the regulations are the more onerous the supervisory process is likely to be.

It is important to recognise that deregulation may often be associated with increased supervision. In the UK deregulation of the Building Societies Act has allowed those institutions to move progressively into areas outside their core deposit and lending businesses. This trend has been accompanied by greatly intensified supervision. As a general rule, the more freedom that building societies have had to do things the more supervision there has been of their ability to do them and how they are done. Indeed, it is arguable that one of the big mistakes in the deregulation of the American housing finance system in the early 1980s was a failure to understand the crucial difference between regulation and supervision. The American savings and loan industry was deregulated so that it was able to enter a wide range of new markets. Simultaneously it was desupervised so that for a period of three or four years the industry was able to conduct business in what subsequently appeared to be an entirely inappropriate way.

The third step of the process relates to enforcement. Once the supervisors have examined the extent to which institutions comply with the regulations, decisions need to be made on what to do if the discovery is made that there is a difference between the way institutions actually behave and the way that the regulations require them to behave. The approach to this can vary from a quiet word from the supervisor behind the scenes, the private approach which is traditionally been that of the Bank of England and the Building Societies Commission to the publicity involved in a fine imposed by one of the regulators for the securities industry established under the UK's Financial Services Act, which was passed in 1986. (Essentially the Financial Services Act provides the framework for the regulation and supervision of both retail and wholesale trading in equities and equity derived products, such as life assurance based savings schemes, and mutual funds. Deposit-taking and lending are outside of the terms of this Act.)

PRUDENTIAL AND CONDUCT OF BUSINESS REGULATION

Over the past few years an important further distinction within the regulatory process has emerged in the UK. For many years the only concern of the regulators and the supervisors was with the prudential health of the institutions for which they were responsible. The concern was to ensure the solvency and liquidity of deposit-taking and insurance institutions, so that they were in a position to repay their depositors in accordance with contractual requirements, or meet claims as insured events occurred.

In recent years a further layer of regulation has emerged relating to the way in which institutions conduct their relationships with their customers. Essentially this influences the amount of information given to consumers and the way it is presented. The extreme complexity of many financial services products has increased the opportunity for financial sales staff, incentivised by commission payments, to provide products to their customers which are inappropriate to their needs and difficult to escape from without loss. In contrast, prudential regulation relates to the necessity of ensuring that there is an appropriate flow of management information within an organisation and between the organisation and its supervisor. Of course, the two objectives may conflict. Prudential pressure to increase capital may result in an institution operating in a manner that attracts the displeasure of a conduct of business regulator.

INSTITUTIONAL AND MARKET REGULATORY ACTION

A further debate has arisen in the United Kingdom over whether supervision should be based on types of institution or on the markets in which they operate. In general terms prudential supervision has been undertaken on an institutional basis. Thus, even though banks and building societies perform essentially the same functions of accepting deposits and making loans, they are supervised by two different authorities, albeit on a fairly consistent basis. Some commentators in the UK have called for a merger of the supervisory section of the Bank of England with the Building Societies Commission. However, there is currently little support for such a change either among building societies or apparently the Government. In contrast, conduct of business regulations, established under the Financial Services Act, govern the wholesale and retail securities markets irrespective of the type of institution involved in a particular business.

SELF-REGULATION AND STATUTORY REGULATION

A further distinction in the UK is that between self-regulation and statutory regulation. There has been a heated debate in recent years over this particular split in relation to the securities business. The Financial Services Act, which provides the framework for this market, resulted in the creation of a number of what are termed self-regulatory organisations, where the membership of the ruling committee is made up of representatives of the industry as well as representatives of consumers academics, etc. In contrast, the Commissioners who sit on the Building Societies Commission have no connection with the building society industry, and at any one time only one out of the seven or eigh Commissioners has had previous executive responsibilities within the industry. The major question has been to assess the extent to which institutions should get together to regulate themselves collectively and each other individually. The pattern ir the UK has been for prudential regulation tc be based on institutional distinctions and or statute, while conduct of business or sales regulation has been based on markets anc has been self-regulatory.

As a general rule this is probably appropriate. There is little likelihood of institutions agreeing in competitive markets that prudential regulation should be undertaken by their peers. The risk of commercially sensitive information becoming available to competitors is too great for prudential regulatior to be conducted by the industry. This however, has not always been the case The Building Societies Association itsel has, in the past, been responsible for some prudential regulation.

Turning to the retail securities market it is difficult to argue that the methods used tc sell equity based life insurance policies by subsidiaries of banks and subsidiaries o building societies should be regulated by different supervisors. There are stronge arguments in favour of a market basec regulatory system for conduct of business i.e. what actually happens in the marke place, than there are for prudential regulation, where institutional differences are more important. There is probably also a case fo a greater institutional input into conduct c business rules than prudential rules, al though there is, of course, an importar place for consultation between, say, the Building Societies Commission and build ing societies when it frames its regulator and supervisory policies. Nevertheless, can be argued that practitioner input inte the conduct of business rules is even more important than into prudential rules. It is quite impossible for outsiders, be it civil servants or public interest representatives, to be wholly aware of the practical consequences of laying down particular rules for the way business ought to be conducted. In the UK this is one of the reasons why conduct of business regulation has been broadly practitioner based.

INTERNATIONAL REGULATION

A further key distinction in the regulatory process is the extent to which it is internationally, or nationally, based. In the UK it has tended to be prudential regulation that has had the greatest international input, whereas conduct of business regulation has essentially been based on national markets. For UK building societies the five key regulatory directives emanating from the European Community have been:

- **The Solvency Ratio Directive**. This defines how much capital a credit institution requires. The European Directive essentially follows the guidance agreed by the Basle group of regulators, which include representatives of the American and Japanese central banks as well as those of Europe. (For building societies the Directive has had little overall effect as they held capital comfortably above the 8% minimum specified. At the end of 1993 the average building society solvency ratio was over 13%.)
- **The Own Funds Directive** which defines the nature of those funds that can be regarded as capital. Again, this included all types of funds previously regarded as capital by societies.
- **The Second Banking Co-ordination Directive** which gives a "passport" to credit institutions so that if they are authorised in one European state they are automatically able to operate in any of the other 11 states without further authorisation.
- **The Deposit Protection Directive**. This will provide minimum standards for deposit protection schemes which apply to all deposit-taking financial institutions within the EC. Although this has been adopted by the Community, the German Government has recently launched a challenge to the Directive in the European Court of Justice.
- **The Money Laundering Directive** which provides common standards across all deposit-taking financial institutions within the 12 nations.

It is important to recognise that European based regulation is just that. There is no European wide supervision or enforcement. Rather, national agencies need to translate the directives into national law and then ensure that they are implemented at national level.

TOO MUCH REGULATION?

There are two major problems with regulation. First of all regulators can be slow to respond to market pressures. Indeed, it is worth emphasising a general rule: markets will almost always move more quickly than regulators. Secondly, the regulations may provide for the provision of so much information to customers that both they, and the staff of institutions become confused, giving and receiving inappropriate messages.

One good example of the speed of change argument in the United Kingdom relates to the regulations covering APRs, annual percentage rates of charge, or in American terms, truth in lending. These regulations are supposed to provide a common and consistent method across all institutions for the expression in advertisements of the mortgage interest rate to be charged on a loan. The problem is that the regulations have not been capable of being altered rapidly enough to reflect the changes that have occurred in the UK mortgage lending market in recent years, in particular the introduction and increased popularity of fixed rate mortgages (the period of fix can vary from anything between one and 10 years, and occasionally as far as 25 years), and the impact of the introduction of variable rate mortgages which are heavily discounted for the first one or two years of their operation. In the UK it is interesting to note that the APR regulations are one of the few examples in the financial services area of statutorily based conduct of business rules that cover a market rather than a group of institutions.

If markets change more rapidly than regulations it is probably fair to say that staff training struggles to maintain pace with regulation. One of the great difficulties for large organisations with many branches is to ensure that all customers receive exactly the same advice and information from all branches. Maintaining consistency across a widespread branch network is almost impossible. One suspects that whatever the level of resources which financial institutions put into staff training it will still be possible for consumer representatives to find examples of differing attitudes taken within and between organisations, and to publicise these differences.

In some cases adhering to regulations can result in a significant breaking down of relations with the consumer. Many legitimate customers are frustrated about the procedures which need to be gone through in order to open a simple savings account following implementation of the anti-money laundering procedures. Customers find that their identity is questioned by staff and that they need documentation not easily to hand in order to open an account.

Similarly, customers often complain about the small print in mortgage lending and consumer credit contracts. Many such words are required by regulation. Unfortunately, there is a conflict between customers receiving the wide range of information which some believe they need before being able to make an informed decision about the type of product to purchase and the organisation from which to purchase it, and the amount of information customers can actually absorb when making that decision.

THE UK GOVERNMENT'S DEREGULATION INITIATIVE

The Conservative Government in the United Kingdom has been keen to emphasise its deregulatory credentials. It has expressed the view on a number of occasions that many regulations do not protect the consumer, while at the same time significantly reduce producers' efficiency. The Government's *Deregulation and Contracting Out Bill*, which is expected to become an Act by the end of October 1994, allows a minister to make an order to "amend or repeal legislation which imposes or authorises or requires the imposition of a burden affecting any person in the carrying on of a trade, business or profession or otherwise, provided that necessary protection is not removed". In other words the Deregulation Bill gives ministers the opportunity of taking a short-cut through the deregulatory process and rather than having to submit primary legislation to Parliament in order to amend an existing Act, it is able to submit secondary legislation which has a much truncated Parliamentary procedure, if the result of that process is to reduce "a burden" without reducing any "necessary protection". The Bill itself includes a number of deregulatory provisions. Many of these are extremely minor, for example, in certain circumstances it will now be possible for children under the age of 14 to go into a British pub as long as they are accompanied by an adult, and the pub has been granted a children's certificate by the authorities. Another repeals legislation requiring shops to close early on one day of the week. Given that these existing regulations are widely ignored some feel that the Deregulation Bill will not have any great effect! Nevertheless, one or two useful changes to the regulation of building societies will emerge from the process.

THE REGULATION OF BUILDING SOCIETIES

The UK Government is currently undertaking a more fundamental two-stage review of building society legislation. This was announced on the same day in January 1994 on which the Deregulation Bill itself, covering a much wider range of areas than building societies alone, was published. The building society legislative review is in two stages. The first was completed at the beginning of July and resulted in building societies being given additional powers to raise wholesale funds (the limit on wholesale funding will be raised, with the necessary legislative amendment being made through the Deregulation and Contracting Out Bill process, from 40% to 50% of total liabilities), to undertake greater general insurance underwriting (in the fields of buildings and contents, and payment protection insurance) and to lend unsecured to corporate bodies. This latter power was included more at the insistence of Government ministers keen to expand the number of providers of finance to small companies rather than at the request of building societies.

The second half of the year will see stage two of the review of building society legislation. One of the major problems with the legislation is that it is currently extremely prescriptive, and the Government has indicated that it is prepared to examine the possibility of making it much more streamlined so as to avoid the need for frequent amendment each time market practice changes. The Government has also said that it will examine a range of relatively minor issues put forward by The Building Societies Association.

Perhaps the most important feature of the second stage of the review is an examination of the accountability of building society boards and managers to their members. This subject is complicated and contentious enough to provide material for a separate article, but one aspect is worth exploring in the concluding section of this paper.

MERGERS BETWEEN BUILDING SOCIETIES AND BANKS

In April 1994 the Cheltenham & Gloucester Building Society (currently the sixth largest building society in the UK) and Lloyds Bank plc announced that they intended to merge. Cheltenham & Gloucester will become a wholly owned subsidiary of Lloyds Bank in exchange for which Lloyds Bank is offering £1.8 billion to be shared out among the members of the Cheltenham & Gloucester. The original Cheltenham & Gloucester plan had envisaged sharing the consideration between all investing and borrowing members of the Society, contrary to most building societies' understanding of the Building Societies Act requirements covering such a merger which were believed to prohibit the payment of funds to all members except investing members of more than two years' standing. The Cheltenham & Gloucester Building Society and the Building Societies Commission went to court to establish the legality of the proposed scheme. The court found in favour of the Commission, indicating that the two-year rule did indeed exist and that payments to investing members of less than two years' standing, and to borrowers, were prohibited. The regulation had been placed in the Building Societies Act 1986 for two reasons -

- It was not felt morally right that short-term investors should be able to obtain a large payout on the basis of a relatively short period of membership of the society.
- It was argued that if such payouts were allowed there would be speculative, destabilising, flows of funds in and out of societies based on media rumours of imminent mergers.

In August 1994 the Cheltenham & Gloucester presented a revised plan which restricted distribution of the sum provided by Lloyds Bank to investing members of more than two years' standing. Accordingly the average payout to investing members will rise from £1,700 to £2,200.

The members of Cheltenham & Gloucester Building Society must vote on the proposal in a general meeting, and 50% of all investing members must vote in favour (or alternatively, holders of 90% of all investing shares by value) and of those who vote 75% must vote in favour. The court decision that those investing members of less than two years' standing were not entitled to a payout has thrown some doubt on the likelihood of the decision going in favour of the Cheltenham & Gloucester management as those members have a vote but no cash incentive to use it. The general expectation, however, is that the required vote will be obtained. In addition, a simple majority of voting borrowers have to indicate their agreement with the proposal. Under the new revised arrangement borrowers receive no distribution of funds, but as a significant proportion of them will also be investors of more than two years' standing it is likely that their interest will be in seeing the merger go through.

The Government is scheduled to publish a consultation document in late September or early October as part of the second stage of the review of building society legislation. As noted this will cover, among other matters, building society accountability. However, the Government has indicated that fundamental changes relating to mergers between banks and building societies will not be announced. It is not anticipated that many societies will follow the C&G route, although similar transactions cannot be entirely ruled out.

CONCLUSION

There are two major factors external to a financial services organisation which determine its success. The first is the state of the market in which it operates; the second is the way in which those markets are regulated. This article has concentrated on the latter. Efficient, fair and considered regulation are essential to the success of any industry or any institution within it. The debate in the UK about the precise nature of financial services regulation, will probably be never-ending. It is, nevertheless, important that all aspects of this important subject are examined and in particular that the different approaches adopted around the world are fully debated. ■

XXI World Congress : IUHFI

London, September 11 - 14, 1995

The XXI World Congress programme is now confirmed, sponsorship has been secured for some of the major events, and members of IUHFI will soon receive a brochure with full details and registration form.

An impressive range of speakers and session chairmen will be taking part in the three day conference, which has the overall theme of *Responding to Change.*

Tuesday 12 September 1995

Eddie George, Governor of the Bank of England, will present the first paper of the Congress on trends in the global economy.

Nasser Munjee, Executive Director and Chief Economist of the Housing Development Finance Corporation, India, will continue the theme with a paper on home ownership expectations, and David Carson, Chairman of the Savings and Community Bankers of America, will bring the day to a close with a presentation on relations between lenders and the state.

Chairing the sessions on the opening day will be Mike de Blanche, President of the International Union, and Mógens Munk Rasmussen, President of the European Mortgage Federation.

Wednesday 13 September 1995

George Fallis, Chair of the Department of Economics at York University, Ontario, Canada, opens the day with a paper on the structural changes in the housing markets of America, Britain and Australia. He is followed by Professor Duncan Maclennan of the Centre for Housing Research at the University of Glasgow, Scotland, who will look at inflation and lending and pose the question, is there an ideal scenario?

Dr Bertrand Renaud, Housing Finance Advisor at the World Bank, will analyse developments in housing finance in Eastern Europe, while Dr Otto Schafer, Chairman of the Bausparkasse Gemeinschaft der Freunde Wüstenrot in Germany, will consider the opportunities and challenges for lenders in mainland Europe.

Carlton Robinson, Managing Director, Trinidad and Tobago Mortgage Finance Company, and Luiz Eduardo Pinto Lima, Vice President, Uniao de Bancos Brasileiros, will be chairing the sessions.

Thursday 14 September

Earl Shulman, Vice Chairman of Seafirst Bank, Seattle, will present a paper on how financial institutions can restructure themselves to reduce overheads, improve competition and gain a competitive advantage.

Stephanie Baeta Ansah, Managing Director of the Housing Finance Corporation of Ghana, will talk about the organisational challenge in Africa, and Mike Blackburn, Group Chief Executive of the Halifax Building Society, will be exploring the diversification options for mortgage lenders in mature housing markets.

Mike de Blanche will wind up with a presentation on the achievements of and challenges faced by the International Union.

The Chairmen on the concluding day will be Ken Culley, Chairman elect of the Building Societies Association, and Andreas Zehnder, Hauptgeschaftsführer, Verban der Privaten Bausparkassen.

Sponsorship and Social Programme

In addition to the welcome party, partners' outings, optional excursions, a reception at the Guildhall in the City of London, and the concluding gala banquet, the World Congress in London will include a golf competition for all levels of players.

The competition will be held on Monday 11 September. It will be sponsored by Unisys, the international computer company, with additional prizes being donated by the Irish Building Societies Association.

Coopers & Lybrand, the largest firm of chartered accountants in the UK, is also sponsoring the Congress. It will be hosting the reception at the Guildhall.

Finally, the British Building Societies will be hosting an enormous welcome party on Monday 11 September. Delegates and partners will be taken from their hotels in central London to Alexandra Palace, on a hill to the north of the city, for a unique night of Victorian entertainment which has been planned with the aim of getting everyone to meet and make friends in the shortest possible time!