

Research Project #5: Comparative Models of Regulation of Risk-Based Industries

Research Paper: Comparative Models of Risk-based Financial Services

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EXECUTIVE SUMMARY

1. This paper is intended to provide an overview of the academic literature concerning two recent innovations in philosophies of regulation (i) principles-based regulation and (ii) risk-based regulation. The paper also canvasses the implementation of these regulatory philosophies by a number of financial and pension regulators, both within and outside Canada.
2. Principles-based regulation (PBR) is usually considered to have the following features:
 - promulgation of high-level standards that are drafted at a broad level of generality
 - a focus on an outcomes-based approach
 - a commitment to enhanced stakeholder participation in the design of principles
 - increased responsibility of regulated entities' senior management for the implementation of principles within firms
 - reliance on constant improvement of industry best practices and guidance with respect to best practices rather than prescriptive rule-making
3. Case studies of principles-based regulation

In this section of the paper, material is presented dealing with the U.K. Financial Services Authority, the British Columbia Securities Commission, as well as a number of DB pension regulators. The U.K. Financial Services Authority (FSA) has adopted 11 "principles for business" which are expressed in terms of outcomes and behaviours, rather than process. The FSA intends that its principles-based approach permeate all aspects of its regulatory efforts; key areas where it has concentrated implementation of the approach include its "treating customers fairly" initiative and new "conduct of business" requirements, along with simplified reporting requirements. Firms that implement appropriate internal management systems so as to achieve the designated outcomes can expect lower levels of regulatory scrutiny; on the other hand, the FSA is prepared to take enforcement action based on failure to achieve principles-based outcomes.

Meanwhile, the BC Securities Commission is the Canadian securities regulator that has most enthusiastically endorsed a principles-based approach, while acknowledging that prescriptive rules may still be necessary where a rule could not achieve the desired result through outcomes-based requirements. In the DB pension regulation context, there is

some evidence of a move to a principles-based approach by the new Pension Regulator in the U.K. This is currently less obvious in Canada and in the U.S., despite supportive commentary from the Chair of the Federal Reserve.

4. Controversies that are discussed in the academic literature with respect to the adoption of PBR include the following;

- lack of certainty for regulated participants, as compared to prescriptive rule-based approaches
- will modes of collaboration in the design of principles systematically favour those regulated participants who are already powerful?
- will existing methods of legal or political accountability for the introduction and implementation of rules (such as notice and comment requirements) require an overhaul to accommodate the more fluid and outcome-oriented approach of PBR?
- what are the conditions under which breach of general, outcome-oriented principles could be the subject of enforcement action by a regulator or indeed, a civil suit?
- specifically in the pension context, could the achievement of the desired outcomes established by a PBR approach actually be effectively monitored by the regulator, given the time horizons involved?
- are all regulated participants equally well-placed to rise to the challenge of incorporating broadly-based principles into the design and monitoring of internal compliance systems?

5. Based on the above material, issues for consideration with respect to shifting to PBR in the Ontario DB pension context include;

- would PBR enhance the willingness of employer sponsors to maintain a commitment to DB pension provision, given evidence of an increasing shift to DC forms of pension as an alternative?
- can the collaborative design of principles be structured so that beneficiary groups and other third-party stakeholders have a consequential role in the process?
- should the broad, outcome-based principles adopted deal with core substantive issues such as arrangements for plan funding, or the investment of assets, or should they be limited to the reduction of compliance costs with respect to more peripheral regulatory requirements?
- in so far as the introduction of a principles-based approach relies more heavily on upgrading internal management and reporting systems within sponsor firms and less on reactive enforcement activity by the regulator, would this be a positive development?

6. Risk-based regimes of regulation have the following common features;

- they emphasize the need for regulation to be proactive and preventive, rather than reactive and enforcement-oriented

- they validate the enterprise of being selective about the regulatory problems that are targeted for attention, thereby acknowledging the possibility that there may be some regulatory failure
- they employ specific risk assessment techniques which tend to be quantitative and probability-based, which often rely on the collection of large amounts of data as well as mobilizing the knowledge of experts both in the design of risk assessment tools and the interpretation of the data thereby gathered
- they rely to an important extent on the development and operation of internal control systems within regulated organizations to manage the risks identified by the regulator

7. Case studies of risk-based regulation

In this section, material is presented dealing with the U.K. FSA, the OSC, the U.K. Pension Regulator and FSCO. The U.K. FSA has developed a highly quantitative instrument for scoring the risk levels of regulated firms. The relevant risks are those that cause harm to the achievement of the FSA's statutory objectives, such as firm financial failure, misselling, or market abuse. The FSA considers risk to reside in the combination of the impact and the probability of an event. For firms assessed as "low impact" (the overwhelming majority of the firms regulated by the FSA), firm-specific risk assessment is rarely carried out.

The Ontario Securities Commission developed a risk-based approach to its regulatory tasks in 2002. Across the span of substantive regulation engaged in by the OSC (continuous disclosure review, registrant compliance etc), various criteria are identified in order to evaluate which activities and participants might be considered "high risk". These enumerated criteria are in general fairly loosely defined, with the most detailed set of criteria to be found in the registrant compliance area.

The U.K. Pension Regulator takes a risk-based approach to regulating its universe of DB plans. The legislative framework under which it operates introduced a "scheme specific" funding framework in 2006 rather than a generalized minimum funding requirement. The Pension Regulator focuses intensively on a small subset of the population of funds, that is, those with more than 1,000 members. It uses a filter mechanism based on two separate triggers to identify schemes whose plans for funding seem to be based on imprudent assumptions. In addition, the PR pays attention to the strength of the "employer's covenant" in specific schemes, thus including a more qualitative dimension to its risk assessment processes.

Finally, information is provided concerning FSCO's current implementation of a risk-based regulatory strategy, in the areas of (i) review of funding arrangements and (ii) plan investments. The data gathered by FSCO as a result of its industry-wide risk-based review of funding suggests that plans have more difficulty with full funding on a solvency basis than on a going concern basis. Some convergence with respect to actuarial practices is evident from the data, particularly with respect to the interest rate assumptions used to value going concern liabilities and the mortality tables used.

8. Controversies discussed in the academic literature concerning risk-based regulation include the following;

-is the process for choosing risk priorities well-founded and transparent? In particular, is there a mismatch between the risk perceptions and risk acceptance of “citizens” and those of the experts designing and implementing risk identification and assessment techniques? If there is such a mismatch, what weight should regulators give to the risk perceptions and tolerance of the public or, in the pension context, of beneficiaries?

-as with PBR above, are all regulated participants equally well-placed to invest in the internal risk management systems that substitute for robust levels of regulator-led reactive enforcement?

-to what extent can risk-based approaches to regulation measure up to traditional indicators of “good regulation”, such as fair and consistent treatment of all regulated participants, or due process protections from the exercise of regulatory discretion?