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Sustainability of Power Sector Reform in Latin America's Small Countries

Carlos Rufin*

Do Latin America's small countries—defined as those with small populations or with electricity markets too small to sustain significant competition—face problems specific to their size when it comes to the sustainability of regulato-

ry reform? This article argues that the specificity of small countries in this regard is a matter of degree rather than of radical differences with large countries, and that threats affect the regulatory regime as much as competition at the wholesale level. Just as there is no

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The United Kingdom's Experience of Creating an Integrated Financial Services Regulator

Phillip Thorpe*

Introduction

There are an increasing number of integrated financial regulators¹ around the globe as governments, ministries and agencies seek to respond to changing markets and a more complex and demanding financial environment.

Today the Financial Services Authority (FSA) of the United Kingdom is probably the world's largest integrat-

ed financial regulator, and can probably also lay claim to having the most diverse remit and most wide-ranging powers. But the FSA is also a relatively recent invention. While the FSA was conceived in 1998 and started to take form shortly thereafter, the final implementation of enabling legislation only occurred on December 1, 2001. In the interim, the FSA had been able to establish its physical form and to construct much of the

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¹ "Integrated Financial Regulator" for the purpose of this paper refers to a single government department or agency empowered to supervise or regulate most or all of a jurisdiction's banking, insurance, securities, derivatives and other investment activities. The actual "mix" of financial services activities included in any agency's remit tends to vary from jurisdiction to jurisdiction.



clear-cut threshold for the minimum size of an electricity market to sustain competition, organizing and running the electricity supply industry on the basis of private capital and competition is not an all-or-nothing proposition. Instead, electricity reform in small countries is characterized by the fact that problems common to reform anywhere are experienced with greater intensity. All wholesale electricity markets have to grapple with issues of market power. By definition, such problems are likely to be more severe in small countries. Likewise, regulatory capture and incompetence can afflict a market of any size; yet a smaller human resource pool—and in Latin America, lower income levels in most of the smaller countries—entail a greater probability of regulatory ineffectiveness.

The Problem Defined

At the heart of the question of reform sustainability lies a time inconsis-

■ *Small countries face two conditions that are likely to exacerbate the possibility of time inconsistency: small wholesale electricity markets and a more limited pool of human resources.* ■

tency problem. The importance and visibility of electricity supply, and the strong network externalities in transmission and distribution, which create natural monopoly conditions and require economic regulation (setting prices for monopoly activities), make the electricity sector especially vulnerable to political interference. Promises made by politicians at the outset of reform to respect the new rules of the game may subsequently be broken, resulting in the expropriation of private investment.¹ Since the time inconsistency arises in the political system, reform sustainability can be then viewed within the framework of transaction cost politics.²

Small countries face two conditions, which are likely to exacerbate the possibility of time inconsistency. On one hand, by definition small countries have small wholesale electricity markets. Only a limited number of suppliers can profitably compete in the wholesale market. In principle, collusion is easier with a smaller number of suppliers. In turn, this creates a greater need for market monitoring and control on the part of the government—in other words, for greater regulation. Yet on the other hand, a more limited pool of human resources and, at least in Latin America, per capita income and economic development levels below the regional average in most small countries are likely to produce weaker institutions.³ Under these circumstances, it is easy to envisage a scenario where weak regulation allows mar-

ket power abuses at the wholesale level to go unchecked, triggering a reaction by aggrieved consumers that leads to a reassertion of political control over the regulator. Short-term political gain then leads to "populist" measures such as draconian price controls that cause the retreat of private capital and the failure of the reform effort.⁴

Upstream Focus

The preceding scenario turns on the likely effects of a concentrated wholesale market and limited regulatory capacity. Growing awareness of the challenge of sustaining competition in wholesale electricity markets—whose complexity and relative novelty set them apart from most other forms of exchange—has rightly focused attention on the upstream side of the industry.⁵ In small countries, the concern is, more specifically, about the impact of large, mostly foreign, generation players whose relative size can stifle competition, overwhelm regulators, and even corrupt the regulators' principals, the politicians. In small countries, the asymmetry between large, foreign developers and the public sector can be significant. The proposed project or projects may represent a very significant proportion of total investment in the country; foreign developers come armed with expertise from previous projects in other countries, often enjoy a sympathetic ear with their embassy, and can play small countries off against more attractive alternatives in larger markets. By con-



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1 Spiller, Pablo, "Institutions and Commitment," *Industrial and Corporate Change* 5(2) (1996): 421-452.

2 Dixit, Avinash, *The Making of Economic Policy: A Transaction-Cost Politics Perspective* (Cambridge, MA: MIT Press, 1998); von der Fehr, Nils-Henrik M., and Millán, Jaime, "Sustainability of Power Sector Reform: An Analytical Framework," Working document, Inter-American Development Bank, Washington, DC, February 2001.

3 Millán, Jaime, and Vives, Antonio, "Reform in Small Electricity Markets: A Single Model?" *Infrastructure and Financial Markets Review* 7(2), June 2001: 1, 4-6.

4 This is not an imaginary scenario, but one that follows, to a large extent, the California crisis. The crisis was the result of a variety of factors, including a faulty reform design, but recent stories in the media about the trading strategies of companies like Enron have certainly reinforced the perception by many in California and elsewhere that market power abuses were at the heart of the crisis. As a result, the state of California has not hesitated to renegotiate the contracts it signed at the peak of the crisis with many of the major participants in the California wholesale electricity market.

5 See, for instance, the work of Professor William Hogan of Harvard University and of the Harvard Electricity Policy Group, at <http://www.ksg.harvard.edu/hepg/>.

trast, many small countries (but not all, witness Costa Rica or Singapore) seek private funds in situations of looming or actual electricity shortages, have few experienced negotiators and experts on this type of transactions, and suffer from weak economies and unstable policies that increase country risk and even corruption. Altogether, these factors can give private developers a strong bargaining position. As a result, power purchase agreements (PPAs) with private developers often entail high prices and shift many project-related risks to the purchaser.⁶ This creates a perception of unfairness in the host country that can make the PPAs and more general reforms politically unsustainable over the long term.

Another threat from large foreign companies observed in Central America is their interest in vertical integration. Vertical unbundling is a key element of sectoral reform,⁷ as competitive markets and consumer choice can be seriously impaired by vertical integration. There are certainly important reasons for vertical integration. Coordination costs between users and generators of electricity—a form of transaction costs—can make vertical integration advisable. Vertical integration can also make sense as a means of protecting upstream investments by acquiring a captive customer base. Lastly, vertical integration may allow the capture of monopoly rents.⁸ On the other hand, it is hard to discern strategic imperatives for vertical integration. Synergies between generation and "wires" are rather weak. The former is a commodity play, where cost

discipline and risk management are essential for competitive success; the latter remains a regulated activity and a service business with a different technological core, network management. And in the context of the creation of wholesale electricity markets, the transaction cost and investment protection reasons become less convincing. A major objective of restructuring is to place generation capacity risks in private hands, under the supposition that demand and supply can be more efficiently matched under well-designed electricity markets than administrative processes. Capacity risk can be diversified by making investments in different countries and industries; it can be shared with other investors or, through contracts, with marketers, retailers, distributors, or consumers. The efficiency goal of reform will be attained when risk sharing is the result of mutual agreement, not of lack of choice by captive customers. And even if the evidence about transaction costs in markets versus plans is not altogether clear, particularly for small markets,⁹ allowing vertical integration would seem to defeat a key objective of reform without giving reform a chance to prove itself.

A variety of solutions have been proposed to deal with these challenges. Rather than relying on PPAs, which usually require some form of government guarantee and which have been shown to be overly rigid, wholesale markets can be created where generators enter at their own risk. In turn, there are many ways of strengthening competition even in small markets¹⁰:

- Vertical integration is perhaps easiest

to deal with. It can be effectively prohibited or limited through a careful definition in the law of the concepts of common ownership and decision-making control.

- In most Latin American wholesale markets, supply bids are required to be based on auditable short-term, or variable costs. The need to make audit threats credible and the problem of valuing water for hydro plants—not an insignificant matter in the region's hydro-dominated markets—limit the impact of this approach, but may help deter outright price manipulation.
- Demand-side bidding effectively turns large consumers of electricity into competitors of generators and can thus have a major impact in small markets.
- Auctioned biddable contracts have been tried in markets, such as Alberta (Canada), where plants of large size relative to the market would make it difficult for their ownership, and hence operating control, to be split.¹¹
- Entry barriers can be kept to a minimum, for instance by ensuring maximum access to various fuels on competitive terms. Historically, governments have often regulated fuel oil prices, and limited the domestic sale of fuel oil to a single public or private oil company. This was the case, for instance, in Panama prior to the privatization of the generation and distribution assets of the "Instituto de

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6 For instance, many PPAs set prices in US dollars, thereby shifting exchange risk on to the buyer; also common is the automatic adjustment of electricity prices according to movements in international indices of fuel prices. For examples of these issues, see ECLAC's analysis of PPAs in Guatemala, "Guatemala: Informe sobre los contratos de compraventa de energía eléctrica suscritos por las empresas del estado en el período 1992-1997" (Mexico City: CEPAL/ECLAC, 7 March 2001).

7 For an early statement of the importance of unbundling, see World Bank, *World Development Report 1994: Infrastructure for Development* (New York: Oxford University Press for the World Bank, 1994), p.53.

8 It is a well-known result in antitrust economics that monopolistic control over any one vertical segment of an industry (such as transmission or distribution in the case of electricity, which are still regarded as natural monopolies) can allow the monopolist to capture rents in all segments of the industry. See Jean Tirole, *The Theory of Industrial Organization* (Cambridge, MA: MIT Press, 1986), pp. 193-198. Even if the monopolistic part of the industry is regulated, vertical integration makes the regulators' task harder, as they have to decide what elements of the regulated company's costs correspond to the regulated activities and which ones correspond to the unregulated component. For the incentives of a vertically integrated firm to pursue anticompetitive practices, see Mark Armstrong, Simon Cowan, and John Vickers, *Regulatory Reform: Economic Analysis and British Experience* (Cambridge, MA: MIT Press, 1994), pp.159-160.

9 There is still much debate about what constitutes a "well-designed electricity market." For an impartial review of the issues involved therein, see David M. Newbery, *Privatization, Restructuring, and Regulation of Network Utilities* (Cambridge, MA: MIT Press, 2000), ch. 6.

10 These measures reflect proposals from a variety of sources. For a more thorough discussion, see Millán and Vives, 2001.

11 Under this scheme, claims on a power plant's output are auctioned off in the form of contracts which give holders the right to submit bids and the obligation to bear their financial consequences, while the plant operator simply has to produce the level of output resulting from the bids submitted by all contract holders.



◀ p.3 **Sustainability of Reform**

Recursos Hidraulicos y Electricidad" in 1998. It is important to recognize the interdependence of policies across the various sectors of the energy industry in order to avoid heightening obstacles to competition in one sector, such as electricity, due to regulatory limitations to competition in fuel supply. Going back to the Panama example, the government recognized this at the time of reform of the electricity sector by allowing private electricity generators to bypass the monopoly seller of oil products in the country and thus obtain fuel on a more competitive basis.

- Given the economies of scale involved in regulating network industries (due to the similarity of the regulatory issues they face) multisector regulators can be created to save on financial and human resources.
- International advisory boards can also be effective ways of strengthening regulatory expertise in small countries, again because the cost of hiring such experts is in effect shared with other countries and institutions.
- Finally, regional integration expands effective market size and thus addresses directly one of the major constraints faced by small countries. In addition, to the extent that regional integration is also accompanied by the creation of supra-national regulatory agencies, the problem of institutional weakness can also be relieved.

Downstream Threats

At the same time, it is essential to realize that the upstream part of the industry is only one side of the coin when it comes to the sustainability of reform in small countries. The other side is the political reaction to reform outcomes. To the extent that outcomes are unaccept-

able, as for instance when wholesale prices are pushed up through market power abuses, policymakers will face pressure to alter the framework created by the reform process. The form this reaction takes will determine whether reform is sustainable or not. If property rights are respected, typically by placing any remedies in the hands of an impartial, predictable dispute resolution mechanism (including an independent regulator), private investors may remain willing to commit capital. By contrast, reform will not be sustainable if adverse political reactions take the form of direct or indirect expropriation, or of the imposition of administrative controls on market participants that leave investment returns at the whim of political office holders. In Guatemala, for instance, upward pressure on electricity prices, itself resulting from PPA provisions and rising world oil prices, has led to repeated attempts to place rate-setting authority back under the direct control of the executive in order to prevent increases in regulated rates required under the post-reform regulatory regime. Arguably, this has been and remains the most important threat to the sustainability of the Guatemalan reform.

■ The upstream part of the industry and the political reaction to reform outcomes are key factors for the sustainability of reform in small countries. ■

The sustainability of reform is thus dependent not only on market size and the competence of regulatory institutions, but more broadly on the rules of the game concerning sectoral policy-making and especially regulatory decision-making—in other words, the rules governing delegation of policy to independent entities. Political actors (politicians, voters, interest groups) may not accept the delegation of rate-making decisions to an autonomous regulator

and thus seek to reverse such delegation, particularly when the outcomes of the reform process have a negative effect on politically powerful forces (typically, when there is upward pressure on electricity rates). We do know that this type of rules vary across countries, as exemplified by the large international variation in the degree of independence of the courts. We need, then, to understand what causes this variation and especially the impact of country size.

Understanding Rules: Rationality and Legitimacy

Research on institutions points to two important determinants of the rules of the game regarding policy delegation: the political logic of delegation, and the process of legitimation of new institutions. Political logic is driven by the rational choices made by political actors about how well their interests will be met under different rules. Legitimation concerns moral or ethical preferences over rules. Different stakeholders may have different preferences about the characteristics of decision-making processes, especially transparency and inclusiveness, which will affect the stakeholders' attitudes about the outcomes of such processes.

There are competing political logics for delegation. "Political blocking" theories¹² show that when political competition among rival parties or candidates is very high (in the sense that the probability of losing the next election is high for the incumbent party) then it is rational for the incumbent to delegate policy so as to make it harder for the opposition to change the status quo if they win the next election. But the "political survival" hypothesis¹³ claims just the opposite. With high rivalry, the incumbent has an incentive to harness every possible resource in order to buy votes at the margin that can make the difference between electoral victory and defeat. Thus, greater political competition will increase centralization of authority

12 Horn, Murray J., *The Political Economy of Public Administration: Institutional Choice in the Public Sector* (Cambridge and New York: Cambridge University Press, 1995); Hanssen, Andrew F., "Is There a Politically Optimal Level of Judicial Independence?" Working Paper 218, John M. Olin Program in Law and Economics, Stanford Law School, May 2001.

13 Ames, Barry, *Political Survival: Politicians and Public Policy in Latin America* (Berkeley: University of California Press, 1987).

instead of increasing delegation. Which logic dominates may depend on how voters make their choices. If clientelistic behavior is common, whereby voters reward politicians who can deliver specific benefits such as local infrastructure or subsidy schemes, "political survival" is likely to prevail. Where voters are more ideologically-oriented, vote-buying will be harder and "political blocking" will be the preferred strategy. Given that small countries in Latin America are mostly poorer than large countries, clientelism is likely to be more prevalent as poorer voters may prefer the pork barrel—which offers more concrete and tangible benefits—to ideology.

Studies of negotiation and negotiation-oriented processes, such as strategy implementation in complex organizations, show that the stakeholders in such processes care strongly about procedural fairness. They are more likely to accept the outcomes if the processes are perceived to be inclusive and participatory, even when the outcomes are not favorable to the interests of some of the stakeholders.¹⁴ Regulation is not unlike negotiation in that it entails reconciling the disparate interests of investors, consumers, and other parties. As such, the acceptability of regulatory decisions is likely to be affected by perceptions about the fairness of the process. Transparent and inclusive regulatory processes are more likely to generate acceptance among stakeholders and thus enhance reform sustainability. In addition, transparency requirements do not just affect the perception of fairness; they also provide an effective means of monitoring the regulator and preventing, or at least detecting, regulatory capture by any stakeholder.¹⁵

In fact, resistance to sector reform in Guatemala, Bolivia, and Panama has been caused, at least in part, by the relative exclusion of household consumers from the reform process. Little effort was made to explain the impact of the reform

to small consumers, particularly the greater role that market forces were to play in the determination of prices for electrical energy. The result has been the perception of unfairness about the reform process—that reform was for the benefit of the foreign investors who bought privatized companies and the large consumers who reaped the benefits of competition and the elimination of cross-subsidies favoring small consumers.

■ Transparency requirements affect the perception of fairness and provide an effective means of monitoring the regulator. ■

Politicians have been quick to grasp the implications of voter dissatisfaction with the reform. They have sought to reassert political control over rates to resist rate increases even if such increases were necessitated by rising fuel prices, by the need to attract new investment, or by the reduction or elimination of cross-subsidies. In small countries, lack of organized consumer representation has made these problems worse, by making it more difficult for small consumers to make their voices heard during the reform process and to channel their frustrations in terms of specific grievances rather than through populist reactions.

Making Regulation Acceptable

The above analysis suggests some clear and concrete policy implications. Procedural fairness is easier to improve than other policies. It entails the development of mechanisms for transparency and participation by small consumers, along the lines that some countries in the region are beginning to develop. Transparency can be ensured through the kinds of regulations developed by administrative law in the United States

and other countries, such as the prohibition of *ex parte* communication during regulatory processes, the obligation to publish reasoned regulatory decisions, and the availability of all documentation presented and used in the process to all participants and the public (bar commercially sensitive data).

Participation by small consumers is harder to achieve and more controversial. It is clear that small consumers lack the time and resources to become experts in regulatory matters, and that a process involving thousands of small consumers would simply be too unwieldy. Yet both obstacles of interest aggregation and technical expertise can be overcome. Aggregation and representation can be attained by leveraging existing entities that work with households on other matters, such as NGOs engaged in community development. Once representative organizations have been established, technical qualification can be easily attained, for instance by grants made by the regulator to such organizations to hire consultants and experts, as practiced by Canada's National Energy Board. Over time, a pool of domestic and international experts is likely to emerge, as is the case in countries with accumulated regulatory experience such as the United States, the United Kingdom, or Chile.

Some analysts also raise questions about the viability of regulatory mechanisms that rely on high-powered incentives, particularly price-cap regulation.¹⁶ These methods increase the stakes of capture for the regulated firm. For instance, as the experience of the Regional Electricity Companies in England and Wales demonstrated, setting too lenient productivity improvement targets can produce large profits for newly-privatized distribution companies. In the institutionally weak setting of Latin America's small countries, with

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14 Lind, E.A., and Tyler, T.R., *The Social Psychology of Procedural Justice* (New York: Plenum, 1988). See also W. Chan Kim and Renée A. Mauborgne, "Procedural Justice, Attitudes, and Subsidiary Top Management Compliance with Multinationals' Corporate Strategic Decisions," *Academy of Management Journal* 36(3), June 1993.

15 McCubbins, Matthew D., Roger D. Noll and Barry R. Weingast, "Administrative Procedures as Instruments of Political Control," *Journal of Law, Economics, and Organization* 3, 1989: 243-277.

16 Estache, A., and Martimort, D., "Politics, Transaction Costs, and the Design of Regulatory Institutions," Working Paper 2073, World Bank, March 1999.



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already high *ex ante* risks of capture, raising the stakes even further makes little sense. But even if capture can be avoided, allowing foreign-owned distributors to earn large profits as a result of a good performance may not be perceived as "fair" by other stakeholders. In a context where political institutions have very limited commitment capacity, the end result could be counterproductive, as privatized firms end up exerting less effort than they would under a cost-plus regime. This suggests that where price-cap regimes are implemented, their rules should be specified in detail to avoid ambiguities that could facilitate capture. This is especially true for setting the productivity improvement target or "X factor." And given the need for large, ongoing investment on the part of privatized distributors (to upgrade service quality and penetration from typically very low pre-privatization levels, and to keep up with rapid demand growth) price-cap regimes should be implemented with specific investment targets that introduce an element of cost-plus regulation.¹⁷

Beyond measures to ensure procedural fairness, we need to consider seriously the potentially legitimizing effects of retail competition. Although retail competition is usually predicated to attain further efficiency improvements and to reduce regulatory burdens, it may play an equally important role in accustoming all consumers to the play of market forces in electricity supply as in any other product (and in creating further stakeholders for reform in the shape of

electricity retailers). Retail competition is often assumed to be unsuitable for less developed countries because of the high cost of real-time metering. However, much simpler methods such as load profiling may do the job adequately. Retailers can compete to supply a certain block of electricity consumption just like generators can compete to build and operate a power plant. The greatest difficulty with retail competition is not, in fact, in the metering side but on the regulatory side. The extreme price volatility of electricity markets makes it incumbent on regulators to ensure that retailers offer adequate protection against price spikes—if for no other reason than preventing political reactions by aggrieved consumers. This can be ensured by requiring retail suppliers to offer a minimum level of price stability and to back it up with strong financial cover.

■ ***Although the problem of clientelism far exceeds what can be done in the realm of sector reform, greater transparency and participation in regulatory processes can diminish the impact of pork-barrel politics on the electricity sector.*** ■

We are left with the issue of political logic and clientelism. This is obviously a matter of much larger scope and complexity than what can be done in the realm of sector reform. Nevertheless, it is important to note that to the extent that transparency and participation in regula-

tory processes, and also the onset of retail competition, make small consumers more knowledgeable about electricity supply, they may become more skeptical about populist promises and thus less inclined to reward "political survival" behavior. For instance, consumers may understand better that indiscriminate rate cuts today can lead to shortages tomorrow, and therefore not heed electoral promises of rate reductions. Reducing clientelism in the system as a whole is likely to take many years of democratic practice and perhaps other broad changes too. But changes in the electricity sector can at least help remove this industry from the pork-barrel schemes that fuel clientelistic politics.

Conclusion

To summarize, relative to Latin America's large countries, the region's small countries face greater, but not radically different, limitations with regard to market contestability, regulatory capacity, political incentives for delegation, and procedural fairness. This obviously reduces in relative terms the sustainability of reform in the electricity supply industry in these countries. There are, however, a number of measures that can alleviate these constraints. Competition in wholesale markets can be enhanced through a variety of means, such as demand-side participation. Greater transparency and participation in regulatory processes will increase procedural fairness. And retail competition might accustom small consumers to the play of market forces and reduce the expectation that the supply of electricity is a matter for governments alone. ■

¹⁷ This is usually achieved through a "Y factor" that provides specific, pre-determined rate benefits to the regulated firm for meeting specific, pre-set investment targets.



◀ p.1 **Financial Services Regulator**

framework integrating its operations. It has also already begun to learn some of the lessons, both good and bad, that come from embarking upon the path to integration.

In seeking to understand the way the Financial Services Authority operates today, it is necessary to understand the political circumstances prevailing in 1998 that gave rise to the decision of the U.K. government to integrate all industry regulators. It is also important to understand the legislative framework behind the FSA: a new, comprehensive piece of legislation creating the FSA, the Financial Services and Markets Act (FSMA), was passed in 2000.

The Background to the FSA

Comprehensive regulation of financial services in the United Kingdom is a relatively recent concept. While supervisory actions have been undertaken in respect of banking and insurance for many years (respectively by the Bank of England and various government departments) the nonbanking financial services sector first saw a regulatory regime only in the late 1980s. That initial legislation (the Financial Services Act of 1986) conceived of a “free market” in regulatory services with a central body (the Securities and Investments Board) to oversee a range of self-regulatory organizations.

That first regulatory system had been in operation for less than ten years when a new Labour government was elected with a policy of overhauling the regulatory system. The reasons for the government’s policy were various:

- There had been a number of noteworthy financial collapses or scandals in the 1980s (BCCI, Barings, Securities, Pensions misselling, etc.) and there was increasing concern that the existing regulatory bodies had failed to produce regimes that were sufficiently robust, or to produce uniformly high standards, or

that they did not have the powers necessary to deal with increasingly adversarial regulated entities.

- The growth of financial services conglomerates and the merging or blurring of lines between financial services sectors (in the U.K. there were no real barriers to banks undertaking securities business, or insurance business, or vice versa) also had led to many institutions complaining of the complexity and inappropriateness of the regulatory system.
- There were also concerns that the structure of regulation allowed different regulatory solutions in different parts of the marketplace despite the fact that products, sales processes and customers were broadly the same.
- Finally, another key aim of the government was the elimination of the self-regulatory concept. Self-regulation was viewed as self-conflicted and an unacceptable mixing of pur-

■ ***The UK’s FSA is probably the world’s largest integrated financial regulator with the most diverse remit and wide-ranging powers.*** ■

poses. It was difficult to be confident in a body that was both governed by and paid for by the industry, and yet had to police and enforce rules over that same industry.

As in any matter driven in part or whole by political considerations, there were other factors that were less directly connected with the regulatory successes or failures of the past. A prime factor in the new government’s thinking was the need to boost investor’s confidence in the marketplace. The new government had a clear understanding of the changing demographics in the United Kingdom, and recognized the need to deal with the increasing burden on the state of pension and health care costs, and of the decreasing ability of the Exchequer to fund those services. The

policy aim was to place responsibility for provision of those services more directly on individuals. And it was implicit that those individuals would only assume those responsibilities if they felt competent to enter the marketplace for those services, and had confidence in the regulatory structure that was intended to protect their interests. The government was of the view that the existing structure did not generate that confidence.

There was also an unrelated structural factor—in the United Kingdom the policy relating to interest rates had previously been a political decision. The new Chancellor of the Exchequer wanted to move that decision-making out of government and into the central bank (the Bank of England), at the same time giving the Bank full independence. The solution he promoted was to give interest rate policy to the central bank, but he also removed bank supervisory matters to a new authority—the FSA.

The New Legislation

To achieve the necessary reforms, the new government determined to consolidate and overhaul existing legislation, and the result was the Financial Services and Markets Act 2000. It is described as “skeleton” legislation, inasmuch as it provides a series of broad powers to the regulator, but does not seek to write-in the detail (broadly speaking the rules and regulations of the FSA); these are for the FSA to prescribe. This legislation is groundbreaking in a number of ways.

- For the first time in financial services legislation, it states a series of statutory objectives, namely:
To maintain confidence in the UK’s markets. In some countries market confidence would be purely a central bank matter. The FSA’s objective of market confidence sits alongside the Bank of England’s responsibility for the stability of the system as a whole.
To promote public understanding of the financial system, which takes the Authority into the provision of information to consumers, and indeed

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◀ p.7 Financial Services Regulator

financial literacy programs. Relatively few other financial regulators undertake that kind of activity.

To protect consumers, bearing in mind their own responsibilities for their decisions—a relatively familiar objective internationally, though it is rarely accompanied by an explicit caveat emptor clause.

To reduce financial crime. This objective is gaining increasing prominence in the field of financial regulation, particularly since the events of September 11, 2001.

- It states “principles of good regulation,” which included requirements for the regulator to be economic and efficient in the use of its resources, statements that the regulator’s actions should not detract from the responsibility on senior management of institutions, statements on the desirability of facilitating innovation and maintaining the competitive position of the U.K. markets, and the importance of facilitating competition between authorized persons; and,
- It provides an unprecedented set of broad powers to allow the FSA to authorize firms and approve individuals, to make rules and issue guidance, to gather information, to conduct investigations, to seek redress, to fine, publicly censure and prosecute firms and to levy fees.

The Immediate Practical Consequences

In practical terms, the FSA inherited the remit of 10 existing regulatory bodies and responsibility for all banking, insurance, securities, derivatives and investment matters, plus a range of financial activities that had been previously unregulated, including mortgages, some aspects of general insurance business, long-term care products, and a host of lesser functions. It also inherited more than 2,000 staff and around 250,000 registered individuals and 10,000

■ The FSA has four statutory objectives: to maintain confidence in the UK’s markets; to promote public understanding of the financial system; to protect consumers; and to reduce financial crime. ■

licensed institutions. These included firms ranging in size from the largest multinational financial conglomerates, to small one- or two-person financial advisors. The FSA needed to find a way to regulate this enormously diverse population, with that diversity not only evidenced in size and profitability but also in competence, track record and integrity, and in services and products, customer type and focus.

Providing a Unifying Model

As the various components of the FSA came together, literally, in one building, work progressed on establishing a framework for regulating once the FSA obtained its full powers. The proposed new regulatory structure drew upon a familiar trend among regulators to develop a risk-based operating model. The main premise of the model is that regulators have to find a logical means of applying finite resources to an almost infinite number of possible calls upon those resources. Given the huge and complex task the FSA was to face, it was also important for the new model to provide the following *internal* results:

- A transparent and usable design for prioritizing issues and allocating resources;
- An ability to clearly define issues and desired outcomes and to measure the effectiveness of any regulatory actions; and
- A means of liberating staff to be risk identifiers and problem solvers, and not just compliance checkers.

Externally the FSA also needed an operating model that above all else would allow it to defend its use of resources.

In undertaking the design work,

■ The new regulatory structure drew upon a familiar trend among regulators to develop a risk-based operating model. ■

there was an early realization that all FSA actions needed to be capable of being justified as in pursuit of its statutory objectives. At the same time the model needed to recognize that not all firms, individuals, products, services or customers are alike and the FSA would need a basis for recognizing the similarities and the distinctions. Finally, the model would need to provide a risk-based regime that allowed for easy internal and external audit.

As it transpired, the provision of statutory objectives and the “principles of good regulation” in the FSMA gave an obvious starting point. And there was also a clear need for any model to be dynamic; to recognize that the success of particular interventions by the regulator would influence the use of resources in the future, that the world would change, and that there would be outside influences, whether political or market-driven. With all of that in mind, the model chosen is nevertheless a relatively simple structure.

Risk Analysis and Prioritization

At the heart of this model is the need to be able to analyze risks and to determine which risks receive priority. This too turned out to be a relatively simple equation in theory, though the practice is significantly harder to achieve. The simple theory is that a risk priority for the FSA will be the outcome of measuring its impact and its probability.

If a risk is likely to have a low impact but there is a low, medium or even high probability that it will occur, that may produce a low prioritization for the FSA. Conversely a risk likely to have a high impact and having a high probability will inevitably see the FSA devoting resources to it. The key to understanding the FSA approach is to recognize that the FSA is only concerned with risks to the FSA’s statutory objectives and the perceived impact of any risks (if crystallized) and the

probability of the risks crystallizing.

The FSA's Expected Outcomes

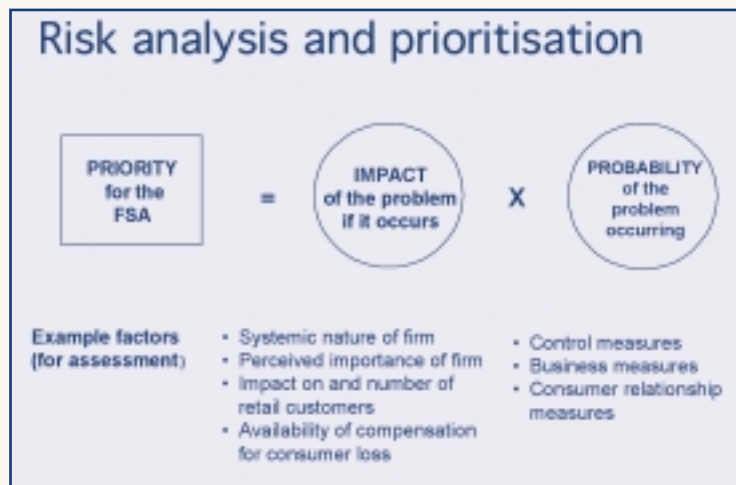
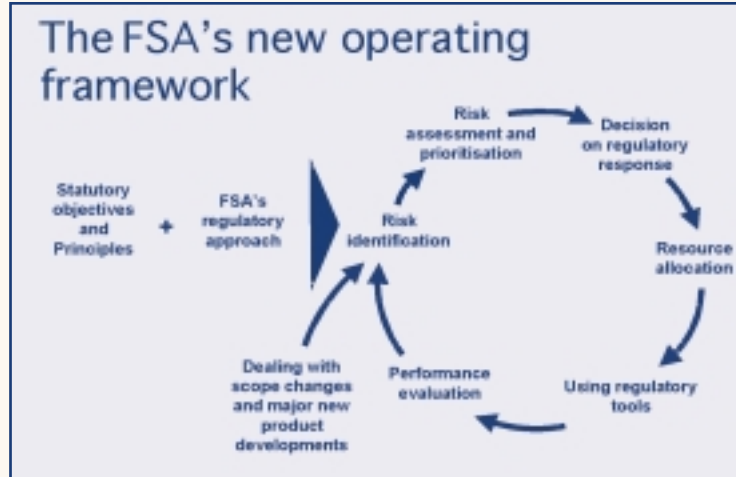
A number of consequences flow from this risk model. The FSA will need to be able to show that it is giving greater weight to those matters that generate greatest risks and that it is selecting the appropriate tools from among its resources and applying them accurately to those risks. The FSA will also need to state in advance what it sees as the key risks in the future and what resources it expects to devote to those risks. And finally, it must state what the expected outcomes will be from applying its resources.

Performance measurement, that is working out whether a regulatory intervention has achieved value, both in terms of money spent and risks averted or damage mitigated, has been a problem for most financial services regulators. An early challenge for the FSA has been in designing credible means of measuring performance and ascertaining desirable outcomes.² Another important measure of the FSA's success will be whether the risk assessment process brings it closer to being a proactive and preventative regulator, making interventions that mitigate risks at an early stage and preventing issues from becoming problems.

Demands on the Regulated Community and Consumers

The new legislation also imposes requirements upon both the regulated entities and consumers. As noted above, these are identified in the statutory objectives and general principles (for instance in the requirement to promote public understanding of the financial system). The FSA has already embarked upon a major campaign of educating consumers in three key respects:

- Firstly, to reinforce the importance of consumers taking responsibility for their own actions and to ensure that they understand the concept of *caveat emptor*.



- To commence a long-term program of improving consumer understanding of financial services. This has included education in the classroom and working to promote financial literacy through a wide range of school ages, to workplace education about particular financial decisions (pensions, health plans, etc); and
- By improving the quality and usability of information provided to consumers, to allow consumers to make more informed decisions about products and markets.

Creating an Understanding of the FSA's Remit

The educational efforts are important in delivering the FSA's objectives, but they also constitute a useful element

of the larger task of managing expectations. There is a danger that in creating such an all-embracing regulator with a wide range of powers, the government has also created a moral hazard; that there is an expectation that the FSA will be able to solve all problems and make good all losses.

The FSA has therefore seen it as important to lay out clearly what it can do and can't do. A substantial amount of work has gone into educating politicians, the press, and the public more generally into the range of actions the FSA will take. The FSA is also very aware that this is unlikely to dissuade politicians from calling for further FSA action whenever a failure does arise.

² See the FSA's latest publication on this topic, "Our Approach to performance evaluation," January 2002, and the companion document, "Financial Risk Outlook 2002."



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Transparency and Accountability

While transparency has been a key goal of the FSA, it is also a requirement of the FSMA, and it takes many forms. The FSA is required to hold an annual public meeting and to publish a range of annual documents—accounts, a plan, budget, its proposals on fees, and there are also annual reports from its consultative bodies. It is also required to publish proposals for any new rulemaking, to publish responses it receives, and to publish its conclusions from those responses. The FSMA has also provided for a “practitioner forum” to provide constant feedback to the FSA on the impact of its actions on the industry it regulates, and a “consumer panel” which provides a similar commentary from the consumer’s perspective. Both these bodies have the right to comment on the actions of the FSA and to publish their views, and to require explanations when the FSA chooses to take an action contrary to their views.

Governance of the FSA

The FSA was established as an independent authority at arm’s length from government with a board of executive and non-executive members appointed by the government, with the executive appointed for fixed terms. The FSA Board appoints the practitioner forum and consumer panel mentioned above, and other panels have been established by the Board to meet specific needs.³ A memorandum of understanding has also been executed which formalizes a tripartite arrangement involving the Bank of England, the FSA, and the Treasury to consider issues of systemic stability. In day-to-day practical terms the executive members of the Board, together with the executive staff of the FSA are responsible for its operation.

To deliver the FSA’s program of work a new organizational structure has also been required. This has resulted in a

highly integrated design, which endeavors to bring together common functions into single units. Efforts have been made to leave behind old terminology, and so there is now a “Major Financial Groups” Division (within a Deposit Takers and Markets Directorate), which regulates around 50 of the largest financial groups in the United Kingdom, regardless of whether they were previously banks, insurance companies or other types of financial institution.

Practical Issues for the FSA

While the FSA has yet to establish a track record (at the time of writing it has had less than a year of full operation) it is already clear that it will need to avoid or overcome some predictable organizational issues. These include:

- *The Supertanker Syndrome* – With an organization of this span and size, there may be a tendency to doggedly pursue a direction, even after inputs for a change have been made. The capacity to move resources rapidly will be key for the FSA’s future ability to respond to new risks.
- *The Principal Resource of Any Regulator Is Its People*—this has its pluses and minuses. Among the pluses for the FSA is that it has a huge reservoir of experience across a diverse spectrum of financial activities. Amongst the minuses is the inevitable desire of many individuals to avoid change. The FSA needs to be able to deploy its resources to new areas, without alienating its staff or losing efficiency.
- *The Distraction of the Latest Calamity*—Given the complexity of resource allocation and the importance of keeping to the FSA’s statutory objectives, it will be vitally important for the FSA not to be moved off course by whatever is taking the headlines on any particular day.
- *Meeting the Inevitable Challenges*—The new powers in the FSMA have not been tested in practice, and individuals or institutions can be expected to contest their application. This may generate a risk of the FSA only

picking fights it knows it can win; timidity or conservatism will be unfortunate outcomes for the FSA.

“The Dogs That Didn’t Bark”

There are probably few within the FSA that would have conceived of the FSA in its current form. Among the many pleasantly surprising outcomes was the realization that the various regulators and supervisors joining the FSA shared broadly common views of the outcomes they were pursuing, though they often expressed those views in different languages.

Another issue that turned out to be less dramatic in practice was in respect of the prudential versus “conduct of business” distinction. For many staff this distinction—as institutionalized in the Australian regulatory reforms—was seen as likely to be the downfall of the FSA. An analysis of the two approaches involved revealed few real differences, with substantial common ground.

And the backstop argument often heard from those unconvinced of the merits of merging prudential and conduct of business regulators—that the former try to prevent failures through working with the institution, while the latter seek conclusions involving prosecution or closure and that these two approaches are incompatible—has not proven to be an issue in practice. There may well be occasions when an institution’s failure may threaten the system’s stability, but such occurrences are very rare, and the ability to deal with those rare instances is not elusive—the key is to have a means of assessing the consequences of the different regulatory actions that may be taken, and a decision-making process for ranking the consequences and acting upon the chosen course of action.

And finally, if there is one overriding lesson to be learned from the FSA experience to date, it probably is that if you wish to embark upon the path to integration, it helps when there is no way back! ■

³ For instance, a Small Business Practitioner Panel has been established to reflect the views of those firms with few employees and relatively modest turnover.

Book Reviews, Articles & Papers:

Privatizations in Developing Countries and the Government's Budget Constraint, *Emmanuelle Auriol and Pierre M. Picard*, University of Toulouse I and University of Manchester, respectively. Working Paper. March 27, 2002.

This paper examines the impact of government budget constraints on the optimal industrial policy for natural monopolies. Governments compare the benefits of taxing profitable public firms with the cost of soft budget constraint and the cost of price and entry distortions. The possibility of transferring resources between the government and public firms generates a soft budget constraint. Governments are likely to transfer too many resources to inefficient firms (through subsidies, taxation, soft bank credit and trade credit). In the model developed by Auriol and Picard, privatization eliminates the soft budget constraint at a cost. On one hand, the government is not able to take advantage of the positive cash flows of profitable firms. On the other hand, consumer costs increase because weak institutions cannot credibly enforce regulation and concession contracts. For example, in Latin America, concessions have been renegotiated after an average of only 2.1 years.

The paper's conclusions have a direct correlation with the sustainability of reforms in infrastructure. For example, it might be disputable for a small country with cheap inframarginal hydroelectric generation and scarce public funds to exchange a virtual perpetuity of rents in public hands for a lump sum that will be dissipated in the public budgeting process. The paper shows that when the shadow cost of public funds is high, the government's option to tax the firm is very appealing.

In contrast, when the shadow cost of public funds is low, the government prefers to set prices equal to marginal costs and subsidize the firm's fixed costs. The government prefers to let a private firm operate in the market for intermediate values of the shadow cost of public funds. For very low values (when bailouts are cheap) or very large values (when holding up a profitable firm is valuable) it prefers to have a public natural monopoly. That is, while divestiture of profitable firms may be optimal in developed countries, the authors contend that it is not necessarily optimal in developing countries where budget constraints are tighter.

In industries with low profitability, the optimal policy is monotone in the shadow cost of public funds (for lower values, a public structure is preferred; for higher values, privatization is optimal). This is simple to understand: privatization is the alternative to the absence of public investment. It is better to have a private firm charging monopoly prices than no infrastructure at all.

This paper is available at: <http://www.idei.asso.fr/Commun/Articles/Auriol/privatization.pdf>

J. B.

Asset Liability Management: A Guide to Value Creation and Risk Control, *Jean Dermine and Yousef Bissada*, Publisher: Financial Times/Prentice Hall. March 2002.

At a time of increasing pressure on banks from various sources (i.e., central banks, regulators and supervisors as well as shareholders and depositors) to create value, the book *Asset Liability Management* brings together the techniques every banking professional needs to use to maximize value creation and minimize risk.

The authors are two experts in the field: Jean Dermine is professor of banking and finance at INSEAD, and Director of the INSEAD Center in International Financial Services (CIFS); Youssef F. Bissada is owner and chair-



man of Bissada Management Simulations, a company working on software packages for education, professor at INSEAD and consultant for various organizations and corporations.

They cover in a very concise, but effective and systematic way the entire spectrum of asset liability management (ALM). The result is an accessible, practical guide in the inner world of banks with little mathematical sophistication.

The authors begin with a review of the goals of ALM, which is value creation for shareholders, and the techniques available to banking professionals to meet that objective. The sequence of the topics is accurately selected: Return on Equity (ROE) decomposition; profit center management; profit allocation and transfer pricing for deposits and loans; capital adequacy regulations; equity spreads and credit risks in loan pricing; securitization. Policymakers will find this publication of interest because it provides an understanding of how the various pieces of bank financial management fit together to create value; and in that context, how to control risk and evaluate performance on a risk adjusted basis.

The topics are all very relevant for the work of professionals in bank restructuring. Professionals who work in emerging countries will find it particularly relevant because the book answers the question of the relevance of ALM to emerging countries. It seems that despite the different environment, the prescriptions for ALM have no boundaries and should fully apply to financial institutions around the world and to private as well as public sector banks.

One topic of particular interest is the pricing of loans to reflect credit risk and provisioning and ultimately identifying the interest margin on loans to



satisfy shareholders and create value. This is a topic of almost everyday interest, particularly in dealing with public sector banks that onlend to so-called first tier banks.

Other issues discussed in-depth in this book are controlling interest rate and liquidity risks, repricing and simulation as well as a full chapter on forward, financial futures and options. It also includes a CD-ROM, a glossary, and an extensive set of exercises and solutions.

It is definitely a book for bankers, bank auditors, central bankers and

banking consultants concerned with asset liability management as well as for policy makers, regulators and supervisors.

P. M.

Events:

Workshop “Developing Bond Markets in Latin America and the Caribbean: Analytical Framework and Issues for the Region.” August 9, 2002

The Infrastructure and Financial Markets Division and the Office of Learning hosted a one-day workshop

to discuss the importance, benefits and difficulties inherent in the development of debt markets. The workshop was the first stage of an initiative to exchange ideas between Inter-American Development Bank staff and experts from the region.

The event focused on four main topics: i) Bond Market Development: Analytical Framework and Issues for Latin America and the Caribbean; ii) Development of Government Bond Markets; iii) Development of Corporate Bond Markets; and iv) Experiences from Country Cases.

The papers presented at the workshop are available at: http://www.iadb.org/sds/IFM/publication/publication_495_3030_e.htm.

The Infrastructure and Financial Markets Division invites you to visit our Website

www.iadb.org/sds/ifm/

The Infrastructure and Financial Markets Division of the Sustainable Development Department provides technical and advisory support, research and dissemination within the IDB group. This mission is accomplished through the development of policies and strategies, training programs, and dissemination of best practices.



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