



In defence of principles

Principles-based regulatory frameworks should not be confused with 'light touch' regulation. In light of the March 2009 Turner Review, the ICAEW continues to support the ongoing development of principles-based regulation in the financial services sector. We believe principles can provide a more robust and flexible regulatory environment than a prescriptive, rules-based system. A rigorous supervisory approach is essential for applying regulatory principles.

A. Introduction to principles-based regulation

It is important to understand the difference between principles-based regulation and rules-based regulation. A principles-based approach does not imply unbridled regulation or an absence of rules. Principles-based regulation involves placing greater reliance on principles and outcome-focused, high-level rules as a means of achieving regulatory objectives, and less reliance on prescriptive rules.¹

The ICAEW welcomes the Turner Review's clear rejection of the term 'light touch'. Equally we welcome the Financial Service Authority's (FSA) articulation that it has '*always considered itself to be principles-based in carrying out its supervisory work*', and that '*it is an outcomes-focused regulator, firmly committed to a risk-based and proportionate approach*'.² The ICAEW does not believe that a change in direction on principles-based regulatory policy would be an appropriate response to the financial crisis. Principles-based regulation must not be confused with being light touch regulation.

Broadly, in supporting the development of Principles Based Regulation, we believe:

1. A principles-based regulatory framework can be just as, if not more, robust than a rules-based regulatory framework.
2. Principles-based regulation is better equipped to adapt effectively to continuously changing circumstances, and to implement requires highly skilled and competent supervision.
3. There is significantly less room for unethical behaviour in a system guided by principles which is well supervised, in contrast to a rules-based framework that does not address substance.
4. Rules-based systems can create a box ticking mindset and compliance cultures, where the focus is upon meeting the letter rather than spirit of the regulation, or an attitude of 'anything goes' so long as it is not prohibited.
5. We note, in light of the current crisis, that the USA's rules-based regulatory framework did not cope demonstrably better than the UK's principles inclined system.

¹ Financial Services Authority, *Principles-based regulation: focusing on the outcomes that matter*, April 2007

² Financial Services Authority, *A regulatory response to the global banking crisis DP09/2*, March 2009

B. The need to develop a 'new supervisory approach'

Principles-based systems need to be supported by effective supervision due to the fact that the application of principles involves a significant element of judgement. The application of principles-based regulation requires regulators to effectively challenge management. This includes the appropriate scrutiny of both the systems and the information supporting management decision making. To be able to do so will require competent, highly skilled and experienced supervisors.

In light of the Turner Review, the ICAEW supports the intention to '*underpin a different philosophy of regulation*' which is more systemic, but emphasises that the supervisory capacity of the FSA should be strengthened within a robust principles-based regulatory framework.³ This may require increased resources and new skills brought into the FSA's supervision teams.

C. The balance between rules and principles

The ICAEW believes that in specific circumstances a simple rule can be the most efficient way of achieving a desired outcome. Principles will provide a basis upon which a detailed, flexible and competitive framework can be developed. Under a principles-based regulatory framework, rules can be interpreted according to the underlining principles.

D. The ICAEW

The ICAEW is a world leading professional body working in the public interest. The ICAEW provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and business to uphold the highest technical and ethical standards. The positions in this briefing draw on the practical experience of members and wider stakeholders in the ICAEW's Financial Services Faculty. We invest heavily in thought leadership programmes which inform our overriding objective to identify and help implement workable solutions to the problems of the global credit crisis and economic downturn.

FURTHER INFORMATION

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³ Financial Services Authority, *The Turner Review: A regulatory response to the global banking crisis*, March 2009