

# **Competition Review of the Financial Services and Markets Act 2000**

**Report prepared for the OFT by Oxera**

November 2004

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# 1 SUMMARY AND CONCLUSIONS

## Overview

- 1.1 The Office of Fair Trading (OFT) launched the 'Review of the Impact of the Financial Services and Markets Act 2000 on Competition in the Financial Services Sector' in November 2003.<sup>1</sup> Oxera was engaged to sift through the Financial Services and Markets Act 2000 (FSMA) and the markets to which it applies, to look for indications of any negative impacts of the FSMA on competition. This report contains Oxera's conclusions.
- 1.2 Oxera has not found any indications that the FSMA has had a potential significant adverse impact on the structure of competition in financial services markets. Where the markets examined are relatively concentrated, with high barriers to entry, this seems to have resulted from other characteristics of the markets in question rather than from the FSMA. Where there are market failures, the FSMA has a positive impact on competition, by addressing these failures and hence improving the way markets function.

## Scope and methodology

- 1.3 The FSMA came into force in December 2001 and created a new regulatory regime for the UK financial services industry. The FSMA sets out a general regulatory framework, and provides the Financial Services Authority (FSA) with regulatory powers subject to the four regulatory objectives established in Section 2(2): market confidence, public awareness, consumer protection and reduction of financial crime.
- 1.4 At the end of 2003, the OFT launched the FSMA Competition Review. This forms part of a broader two-year review of the FSMA, announced by HM Treasury on November 4th 2003.<sup>2</sup>
- 1.5 The OFT structured the FSMA Competition Review in three stages and engaged Oxera to undertake the research for the first two stages. Stage 1 involved the design of a 'sifting' methodology to identify the key areas where the FSMA may have had a significant impact on competition. The report for Stage 1 was published in March 2004.<sup>3</sup> Stage 2, the subject of this report, involves the

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<sup>1</sup> OFT (2003), 'OFT Role in Review of FSMA', PN 142/03. This report refers to it as the FSMA Competition Review.

<sup>2</sup> HM Treasury (2003), 'Statement on the Two Year Review of the Financial Services and Markets Act', Statement FST 04/11/03, November 4th.

<sup>3</sup> Oxera (2004), 'Review of the Impact of the Financial Services and Markets Act 2000 on Competition', report prepared for the OFT, OFT 714, March.

application of the sifting methodology to all relevant activities and markets to which the FSMA applies. In Stage 3 the OFT will consider whether any aspects of the FSMA identified in Stage 2 should be subject to further investigation.

- 1.6 As the FSMA largely constitutes a general legislative framework, any *direct* impact of the FSMA on competition is relatively limited and difficult to observe. A direct impact on markets is more likely to result from the detailed rules and regulations in the statutory instruments and the FSA Handbook, and from specific actions and decisions by the FSA.
- 1.7 To deal with the fact that the FSMA constitutes a legislative framework only, Oxera has combined a 'top-down' analysis of the FSMA with a 'bottom-up' analysis starting from the 18 'high-level' financial services markets that are covered by the FSMA, as identified by Oxera. (These are defined more broadly than the 'relevant markets' usually defined in competition policy.) This analysis carefully reviews the *conditions of competition* and the presence of *risks and market failures* in each of these markets. In addition, Oxera has taken into account FSA rules and statutory instruments where relevant, not as an end in itself but only to obtain further insight into the potential direct and indirect competition effects of the FSMA, as that is the focus of the Review.
- 1.8 The bottom-up analysis allows the identification of markets where (structural) competition problems are more prevalent. In those markets, it is necessary to assess whether these problems can be attributed to the FSMA or to other factors. Furthermore, the assessment of market failures in each market is important to understand the rationale for regulation—where a negative effect of regulation on competition is identified, this should be weighed against the positive effect of the regulation in dealing with those market failures.
- 1.9 It is important to recognise the objectives of this stage of the Review, and therefore the limitations of the analysis contained in this report. The objective of this stage was to sift through markets affected by the FSMA to identify those areas that might raise competition concerns such that the OFT may wish to conduct further research. This report is not intended as an in-depth analysis of competition, market failures or regulatory impact in the financial services industry.

1.10 Three high-level questions guided the Review:

**Question 1:** Does the FSMA unduly distort competitive structure?

**Question 2:** Does the FSMA unduly reduce the dimensions of competition?

**Question 3:** Does the FSMA duly facilitate market functioning?

1.11 Questions 1 and 2 are concerned with the negative impacts of regulation on competition, while Question 3 is also related to the positive impacts on competition. In most high-level markets, there are market failures, which indicates that regulatory intervention can improve outcomes and enhance market functioning. The terms 'duly' and 'unduly' emphasise that the competition impact of regulation, if any is found, still needs to be assessed against the risks and market failures that the regulation is designed to address.

1.12 In addition to other data sources, Oxera conducted around 50 interviews between May and September 2004. We had in-depth discussions on each market with experts from the FSA. We further obtained views and information through interviews with HM Treasury, the Financial Ombudsman Service (FOS), members of the Financial Services Consumer Panel and the Financial Services Practitioner Panel (FSPP), and the Small Business Practitioner Panel, all the major trade associations, some legal experts and several individual financial services firms. Oxera is extremely grateful to all those who have assisted with the research. All errors and omissions remain the responsibility of Oxera.

### **Competition and market failure analysis**

1.13 Oxera's market analysis divided the 18 high-level markets (22 including further sub-divisions) into four types:

- three Type A markets, where both competition and market failure indicators are above a critical threshold—current-account services offered to private and small and medium-sized enterprise (SME) customers, trading infrastructure, and clearing and settlement infrastructure. In these markets, all three high-level questions are of relevance;
- seven Type B markets, in which the competition indicators are below the threshold—which means that they are unconcentrated markets with low entry barriers—but which are characterised by significant market failures. The key questions for these markets are whether the FSMA has affected the dimensions of competition and market functioning (Q2 and Q3);
- four Type C markets, which are concentrated and characterised by entry barriers, but where market failures are relatively limited—credit-rating

agencies, pension fund consultants, investment banking services in relation to initial public offerings (IPOs), and custodian services offered to institutional clients. All three high-level questions are relevant for these markets; and

- eight Type D markets, in which both competition and market failure indicators are below the threshold. These markets are therefore discarded at this stage of the sift.

1.14 These classifications do not imply a verdict on the state of competition in each market. Thus, a Type A or Type C classification does not mean that there are significant competition problems that require scrutiny; rather, it suggests that, in these markets, the competitive structure is such that any potential regulatory effects may be of greater concern.

### **Effects of the FSMA on market functioning**

1.15 It is important to recognise the positive role of financial services regulation in dealing with market failures and hence improving how markets function in the first place. As is generally known, and has been confirmed by Oxera's market analysis, many financial services markets are characterised by pervasive market failures. The main failures are systemic risk (combined with negative externalities)—in particular in the high-level markets for deposit-taking, hedge funds, and clearing and settlement infrastructure—and asymmetric information between buyers and sellers—this exists in almost all retail markets, but also in some institutional markets, such as investment advice.

1.16 The four regulatory objectives set out in the FSMA can all be related to market failures. The FSMA also establishes the general mechanisms for the FSA to address these failures, in particular the authorisation regime, prudential regulation, the conduct of business regime and the market-abuse regime. In addition, the FSMA has created the Financial Services Compensation Scheme (FSCS) (Part XV) and the FOS (Part XVI) as redress mechanisms, which seek to enhance market confidence and protect consumers.

1.17 An important conclusion of the FSMA Competition Review, therefore, is that the FSMA (and financial services regulation in general) is likely to have a positive effect on competition by improving how markets work.

### **Effects of the FSMA on competitive structure**

1.18 Oxera concludes that the FSMA itself is unlikely to have had, or to have, any significant adverse effects on the competitive structure of markets.



- 1.19 The main mechanism through which such effects might have arisen is the authorisation (and recognition) regime, since this constitutes a regulatory barrier to entry. However, the market analysis carried out by Oxera suggests that this regulatory barrier has not deterred entry significantly in any of the Type A and Type C markets (current accounts, trading infrastructure, clearing and settlement infrastructure, credit-rating agencies, pension fund consultants, IPOs and custody). Rather, the relatively high degree of concentration and entry barriers in these markets can be attributed to other factors, such as economies of scale, network effects and reputation effects.
- 1.20 The FSMA has had a direct impact on vertical structure in one high-level market—trading infrastructure—by giving the FSA responsibility for some of the regulatory functions previously carried out by the London Stock Exchange (LSE), ie, the functions the FSA currently carries out as the UK Listing Authority. As explained in the report, the effect is likely to be pro-competitive. From an economics perspective, this change from the previous regulatory regime sets a clearer boundary between public-sector regulation and the LSE, which, besides its regulatory functions, has a commercial imperative and competes with other trading platforms.
- 1.21 Finally, the FSMA, statutory instruments and the FSA rules create regulatory compliance costs to firms, and evidence suggests that this affects smaller firms more than medium-sized and larger firms. This may deter some small firms from entering the market and may have led to consolidations of firms. However, the overall effect on competition is unlikely to be significantly negative, in particular because the high-level markets in which these effects occur have generally been classified as Type B or Type D. This means that, in these markets, overall concentration and entry barriers remain low.

### **Effects of the FSMA on the dimensions of competition**

- 1.22 The FSMA sets out only a general regulatory framework for financial services, with greater detail contained in statutory instruments and FSA rules. These regulations therefore have a more direct impact on the behaviour of firms than the FSMA itself. One exception is in the market for the provision and management of retail funds, where the FSMA creates some differential regulation by addressing certain types of fund directly in the FSMA (collective investment schemes, or CIS, in Part XVII), but not other types that compete to some extent in the same market. The effect on competition may be limited, however, because this market has been classified as Type B (below the threshold for competition indicators).
- 1.23 The FSA rules and decisions may have a more direct effect on the dimensions of competition. Assessing these effects in detail is outside the scope of the

FSMA Competition Review. Here, Oxera notes only that potential adverse effects on competition may arise from FSA rules, as the FSMA gives the FSA considerable discretion in setting and enforcing these rules. This underlines the importance of the competition scrutiny mechanisms that are established in the FSMA in order to prevent or limit such adverse effects. These scrutiny mechanisms are discussed in the next section.

- 1.24 Finally, it is noted that the FSMA Competition Review focuses on UK markets, whereas the Oxera market analysis shows that in some institutional and wholesale markets (for example, institutional fund management, brokerage, trading and custody, and wholesale insurance and banking services), UK firms compete with overseas suppliers as well. In this respect, the FSMA could, in theory, have an effect on competition (either positive or negative) by imposing UK-specific regulation, and several market participants have expressed some concern about this. Oxera did not investigate this issue further.

### **Addressing competition concerns under the FSMA framework**

- 1.25 The promotion or protection of competition is not among the primary regulatory objectives set out in the FSMA. However, the FSMA does establish important mechanisms to limit any adverse effects on competition that may arise from the FSA's rules and decisions.
- First, under Section 2(3), the FSA 'must have regard to' the need to minimise the adverse effects on competition that may arise from anything done in the discharge of its functions, and to the desirability of facilitating innovation and competition. Further, under Part X, Section 155(2), it is required to conduct a cost-benefit analysis (CBA) on new proposed rules.
  - Second, the FSMA gives the OFT an important role in scrutinising the regulatory provisions and practices of the FSA (Part X, Chapter III) and of the recognised bodies (Part XVIII, Chapter II). There is also a possible further role for the HM Treasury, the Competition Commission and the FSA, should an adverse effect on competition be found.
- 1.26 In theory, these mechanisms should be sufficient to prevent or address most potential adverse effects of competition arising from regulation. To assess the effectiveness of these two mechanisms in practice is beyond the scope of the FSMA Competition Review. Here, Oxera emphasises their importance from a competition perspective—indeed, as part of the broader FSMA two-year review, the FSA has been evaluating the way it conducts CBA.
- 1.27 While the FSMA therefore contains mechanisms to prevent adverse regulatory effects on competition, it does not require the FSA to actively promote

competition in areas where this might be beneficial from an economic welfare perspective. This is a direct result of not making competition a primary regulatory objective in the FSMA. While many competition concerns can be addressed under competition law (the Competition Act 1998 and the EC competition rules), there are some areas where a regulator with a specific competition remit (following the example of utility regulators) could arguably go further than the FSA is at present in trying to improve or promote the competitive dynamics of markets.

- 1.28 One such area is access to clearing and settlement infrastructure, which has certain natural monopoly characteristics (and is currently dealt with by the European Commission both under competition law and through proposed sector-specific regulation). Another area would be to seek to actively address entry barriers in the more concentrated markets (Types A and C).

### **Overall conclusion**

- 1.29 Overall, Oxera's conclusion, after carrying out Stage 2 of the Review, is that there are no indications of areas where the FSMA itself might have had a significant adverse impact on competitive structure in the activities and markets that it covers.
- 1.30 A number of markets have been classified as Type A or Type C, which means that market concentration and entry barriers are relatively high. However, this cannot be attributed to the FSMA itself, but rather to other market characteristics.
- 1.31 In other markets, including the Type B and Type D markets, which are less concentrated, there are some indications that overall compliance costs may have deterred some small firms from entering the market or led to consolidations of firms. Likewise, adverse effects on the dimensions of competition may arise from FSA rules, as the FSMA gives the FSA considerable discretion in setting and enforcing these rules.
- 1.32 These observations underline the importance of the competition scrutiny mechanisms established in the FSMA to prevent or limit such adverse effects—in particular, the role of CBA in the FSA decision-making process and the role for the OFT in scrutinising the FSA's rules and decisions. The design and effectiveness of these mechanisms may be topics for further investigation.

## 2 SCOPE AND METHODOLOGY

### Background

- 2.1 The FSMA, which came into force in December 2001, created a new regulatory regime for the UK financial services industry, covering activities related to securities and investment markets, banking and insurance. It established the FSA as the single, statutory regulator, responsible for supervising the activities of a broad range of financial services institutions in the above-mentioned activities.
- 2.2 Other key areas addressed in the FSMA are the authorisation and approval regime—which means that firms involved in 'regulated activities' have to seek authorisation from the FSA—and the conduct of business and market conduct and abuse regimes—which give the FSA far-reaching powers to set conduct rules and deal with abuses. The FSMA sets out the general framework for financial services regulation, with most of the detailed rules and regulations being defined in the statutory instruments, and, in particular, in what is known as the FSA Handbook.
- 2.3 Section 2(2) of the FSMA sets out four regulatory objectives for the FSA: market confidence, public awareness, consumer protection, and reduction of financial crime. From an economics perspective, these regulatory objectives are designed to deal with the market failures that are pervasive in the financial services industry, including, systemic risk, lack of market confidence, asymmetric information between buyers and sellers, and limited financial sophistication and bargaining power on the part of consumers.<sup>4</sup>
- 2.4 Promoting or maintaining competition is not a primary objective for the FSA—ie, the FSA is not a competition regulator. However, the FSMA (Section 2(3)) does state that the FSA, when discharging its general functions, 'must have regard to' the following factors, among others:
- the desirability of facilitating innovation in connection with regulated activities;
  - the need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions; and

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<sup>4</sup> The reduction of financial crime also has the effect of addressing market failures, as it mitigates the risks and information asymmetries faced by market participants and consumers, thereby improving market functioning. The four regulatory objectives in the FSMA are, of course, not exclusively economic.

- the desirability of facilitating competition between those who are subject to any form of regulation by the FSA.

Hence, the trade-off in financial services regulation between addressing market failures, on the one hand, and facilitating/preserving competition, on the other, is recognised explicitly in the FSMA.

2.5 In response to the Cruickshank Review (2000) on competition in UK banking,<sup>5</sup> which raised concerns about whether the new regulatory regime appropriately protected or promoted competition, the government committed itself to review the impact of the FSMA on competition two years after it came into force. At the end of 2003, the OFT was therefore asked to undertake a review of the impact of the FSMA on competition in the financial services sector.<sup>6</sup>

2.6 The review forms part of a broader two-year review of the FSMA that was announced by HM Treasury in November 2003. This wider review addresses some aspects of the functioning of the FSA and of the FOS, and the issue of the boundaries or regulation.<sup>7</sup>

2.7 The OFT has structured the FSMA Competition Review in three stages. It has engaged Oxera to undertake the research for the first two of these stages.

- Stage 1 involved the design of a 'sifting' methodology, which allowed identification of the key areas where the FSMA is likely to have a significant impact on competition. The report setting out the sifting methodology was published in March 2004.<sup>8</sup>
- Stage 2, the subject of this report, involves the application of the sifting methodology to all relevant activities and markets to which the FSMA applies.
- In Stage 3 the OFT will consider whether any aspects of the FSMA identified in Stage 2 should be subject to further study.

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<sup>5</sup> Cruickshank, D. (2000), 'Competition in UK Banking: A Report to the Chancellor of the Exchequer', HM Treasury.

<sup>6</sup> OFT (2003), 'OFT Role in Review of FSMA', PN 142/03, November 4th.

<sup>7</sup> HM Treasury (2003), 'Statement on the two year review of the Financial Services and Markets Act', Statement FST 04/11/03, November 4th.

<sup>8</sup> Oxera (2004), 'Review of the Impact of the Financial Services and Markets Act 2000 on Competition', report prepared for the OFT, OFT 714, March.

## Oxera's approach to the FSMA Competition Review

- 2.8 The first two stages of the Review are intended to identify and prioritise areas that might warrant further study—ie, those where the competition impact of the FSMA might be greatest. Thus, the research in this report takes a high-level approach to direct attention to areas that are likely to be most significant. It does not aim to apply a detailed competition analysis to each market covered by the FSMA.
- 2.9 A fundamental issue facing the FSMA Competition Review is that, as mentioned above, the FSMA largely constitutes a general legislative framework. This means that any *direct* impact of the FSMA on competition is relatively limited or difficult to observe. Such a direct impact is more likely to result from the detailed rules and regulations in the statutory instruments and the FSA Handbook, and from specific actions and decisions by the FSA.
- 2.10 For these reasons, Oxera considered at the beginning of the Review that a 'pure' top-down approach that starts from the FSMA itself would not be the most effective way of assessing the effects on competition. The parts and sections of the FSMA cannot be analysed in isolation; they can only be analysed in the context of the specific statutory instruments and FSA rules to which they give rise and, importantly, in relation to the specific markets they affect. The sifting methodology developed by Oxera therefore comprises a 'hybrid' model that combines a top-down with a bottom-up approach. In addition, Oxera has taken into account FSA rules and statutory instruments where relevant, not as an end in itself but only to obtain further insight into the potential direct and indirect competition effects of the FSMA, as that is the focus of the Review.
- 2.11 The bottom-up approach starts from the financial services markets covered by the FSMA—Oxera identified 18 such 'high-level' markets (see below and in section 3). The analysis carefully reviews the *conditions of competition* and the presence of *risks and market failures* in each of these markets. This allows identification of those markets where structural competition problems are more prevalent. Only in those markets is it necessary to ask whether the FSMA may have affected the competitive structure. Furthermore, the assessment of market failures in each market is important to understand the rationale for regulation—where a negative effect of regulation on competition is identified, this should be weighed against the positive effect of the regulation in addressing those market failures.
- 2.12 Thus, Oxera's approach to the Review has been to analyse competition and market failure indicators in all the high-level markets covered by the FSMA, and to assess the competition effects of regulation in these markets in light of these indicators. This bottom-up approach was complemented by a top-down 'cross-

check' that carefully reviewed all the parts and sections of the FSMA. More detail on the sifting methodology is given in the sub-section below.

- 2.13 It is important to recognise the objective of this stage of the Review, and therefore the limitations of the analysis contained in this report. The objective was to sift through markets affected by the FSMA to identify those areas that might raise concerns that the OFT may wish to study further. The sifting methodology was designed to pick up the most significant areas in a practical way, rather than to conduct an in-depth analysis of competition, market failures or regulatory impact in the financial services industry. There are three issues regarding the sifting methodology that are worth noting here.
- 2.14 First, Oxera did not undertake a full competition review of the markets concerned, but limited the analysis to a number of key indicators of competition and market failures. In this respect, it is worth noting that some of the relevant financial services markets have been subject in recent years to more detailed competition reviews by other institutions. Such reviews include, for example, the Cruickshank Review and Competition Commission inquiry into banking services,<sup>9</sup> the FSA's competition analysis in the fund management and brokerage markets in the light of its review of soft commissions and bundling practices,<sup>10</sup> the reviews by the OFT and FSA of the distribution of investment and pension products,<sup>11</sup> and the European Commission's in-depth review of clearing and settlement.<sup>12</sup> The scope of these other reviews differs from that of the FSMA Competition Review. However, their results have been taken into account directly for the current Review, so as to avoid duplication of effort.
- 2.15 Second, this Review focuses on the competition effects of the FSMA, and not on the effects of the FSA rules or relevant secondary legislation. Indeed, under the FSMA (Part X, Chapter III), the OFT has an obligation to keep the FSA's rules and practices under competition scrutiny—ie, to assess whether there is

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<sup>9</sup> See Cruickshank, D. (2000), 'Competition in UK Banking; A Report to the Chancellor of the Exchequer', March; and Competition Commission (2002), 'The Supply of Banking Services by Clearing Banks to Small and Medium-sized Enterprises', Cm 5319, March.

<sup>10</sup> See FSA (2003), 'Bundled Brokerage and Soft Commission Arrangements', Consultation Paper 176, April; and the accompanying Oxera report: Oxera (2003), 'An Assessment of Soft Commission Arrangements and Bundled Brokerage Services in the UK', report for the FSA, April.

<sup>11</sup> See OFT (1999), 'The Rules on the Polarisation of Investment Advice', August, and FSA (2003), 'Reforming Polarisation: Removing Barriers to Choice', FSA Consultation Paper 166, January.

<sup>12</sup> See European Commission (2004), 'Clearing and Settlement in the European Union – the Way Forward', Communication to the Council and Parliament, COM(2004)312, April 28th.

any 'significantly adverse effect on competition'. The FSMA Competition Review is not intended to duplicate or overlap with this existing role of the OFT.

- 2.16 Third, the Review does not seek to undertake a full CBA of the regulation in each market. Such a CBA would also address aspects including the regulator's costs, compliance costs, distributional effects, and any benefits of regulation other than facilitating competition, which may not be directly related to competition as such.

### **The sifting methodology**

- 2.17 This section briefly describes Oxera's sifting methodology. A more comprehensive explanation can be found in the report for Stage 1 referred to above.

#### **HIGH-LEVEL QUESTIONS**

- 2.18 The remit to review the impact of the FSMA on competition is potentially very wide. Any regulatory framework affects competition in a myriad of ways. The FSMA, together with the large body of secondary legislation and FSA rules, is no exception. Furthermore, the concept of competition can have different dimensions and meanings, and the assessment of the impact of regulation depends on which dimensions of competition are being considered. To focus the scope of the FSMA Competition Review, the impact of FSMA on competition was examined by addressing the following three high-level questions.

**Question 1:** Does the FSMA unduly distort competitive structure?

**Question 2:** Does the FSMA unduly reduce the dimensions of competition?

**Question 3:** Does the FSMA duly facilitate market functioning?

- 2.19 These questions helped to focus the assessment of the FSMA on the most significant potential impacts on competition. The terms 'duly' and 'unduly' emphasise that the competition impact of regulation, if any is found, still needs to be assessed relative to the risks and market failures that the regulation is designed to address, and take into account the balance to be struck between addressing risks and market failures and facilitating/preserving competition.

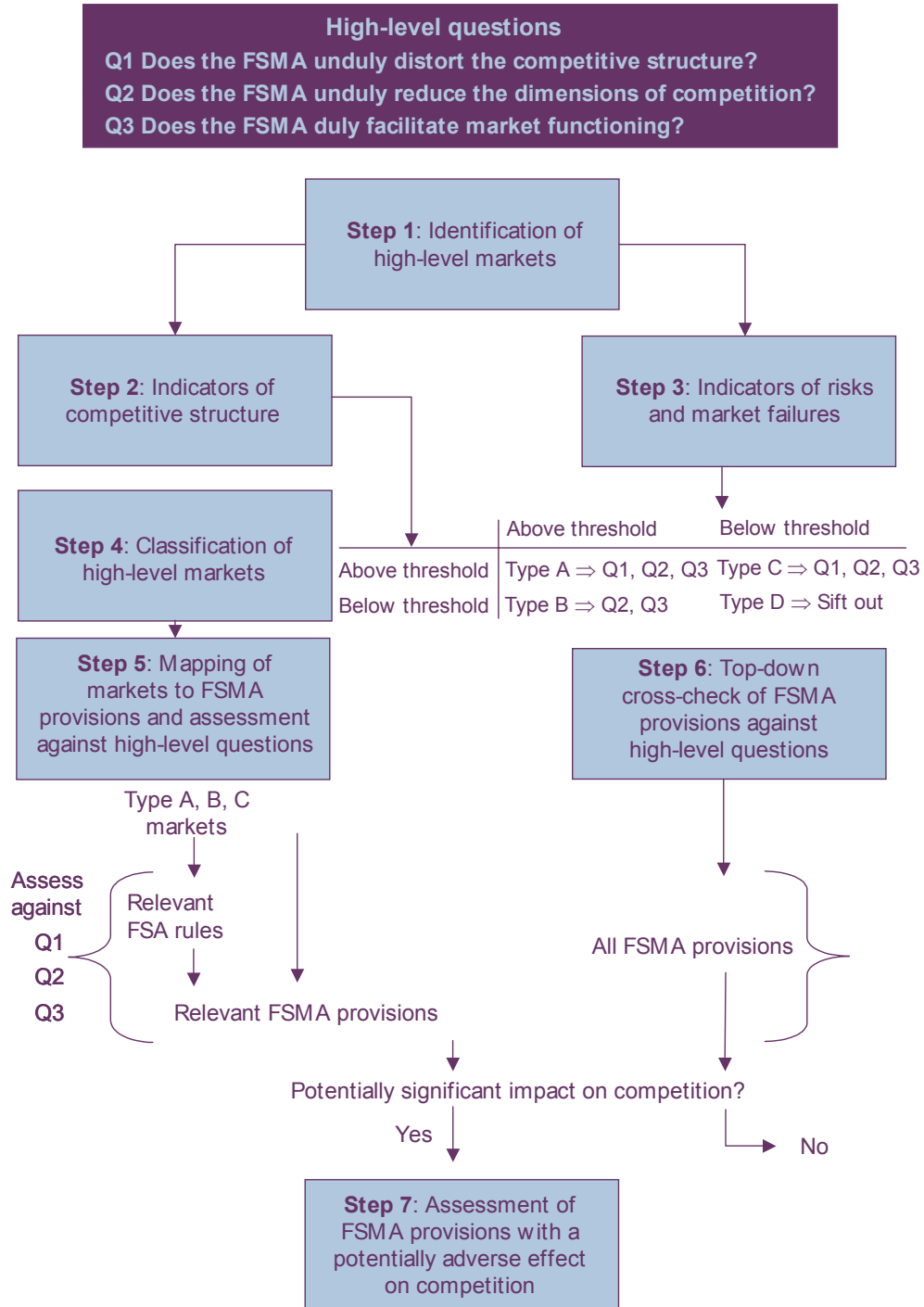
- 2.20 Questions 1 and 2 are concerned with the negative impacts of regulation on competition. They are mainly dealt with in sections 5 and 6 of this report, respectively. In contrast, Question 3 is related to positive as well as negative impacts on competition. In most high-level markets, there are market failures, which indicates that regulatory intervention can improve outcomes and enhance market functioning. These positive aspects are largely addressed in section 4 of this report. Other aspects in relation to Question 3 are examined in section 7.



## SEVEN-STEP SIFTING METHODOLOGY

2.21 The sifting methodology itself consists of seven steps, as illustrated in Figure 2.1 and described below.

FIGURE 2.1 - STYLISED ILLUSTRATION OF THE SIFTING METHODOLOGY



**Step 1** identifies the high-level markets to which the FSMA applies. Oxera identified 18 such markets, as shown in Table 3.1 in section 3 below. These are 'economic markets' for services offered to customers, as opposed to financial markets for securities.<sup>13</sup> They are defined at an aggregate level, although three markets (deposit-taking services, investment advice to institutional clients and investment banking) were further divided into segments to reflect differences in competitive conditions in these segments. More specific 'relevant' markets—defined in line with competition policy principles—may be identified during Stage 3 of the Review.

It is important to note that the Review does not cover activities such as payment services, money transmission, consumer credit, mortgages and general insurance intermediaries. The first three do not fall under the FSMA, while mortgage intermediaries and advice have come under the FSMA only recently, from October 31st 2004, and general insurance intermediaries will be subject to the FSMA from January 14th 2005.

**Step 2** classifies each high-level market according to a range of indicators of the competitive structure in that market leading to a binary classification—ie, markets that are 'above' a critical threshold, which potentially give rise to structural competition concerns, and those 'below' this threshold. The indicators considered are market concentration; entry barriers; economies of scale/network effects; vertical integration; countervailing buyer or supplier power; switching costs; and geographical scope of competition.

**Step 3** classifies each high-level market according to a range of indicators of risks and market failures in that market. This also leads to a binary classification. Markets are 'above' a critical threshold if the risks and market failures are such that there is likely to have been a relatively high degree of regulatory intervention, and hence competition is more likely to have been affected. The indicators considered are operational risk; financial/default risk; systemic risk; negative externalities; asymmetric information (non-transparent product offerings); asymmetric information (non-transparent quality or performance); and public goods.

**Step 4** combines the classifications of Steps 2 and 3 for each high-level market, leading to four market types (Types A to D).

- Type A markets, where both the competitive structure indicators and the risk and market failure indicators are assessed as being above the threshold.

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<sup>13</sup> In the financial services industry, the term 'market' is usually associated with markets for financial instruments such as shares, bonds and derivatives.

- Type B markets, where the competitive structure indicators are below the threshold and the risk and market failure indicators above the threshold.
- Type C markets, where the risk and market failure indicators are below the threshold and the competitive structure indicators above the threshold.
- Type D markets, where both the competitive structure indicators and the risk and market failure indicators are assessed as being below the threshold.

The high-level questions were addressed only for Type A, B and C markets. Type D markets were discarded at this stage because both the competitive structure and the risk/market failures are below the threshold. In principle, adverse regulatory effects on competition could still arise in such markets, but these effects would be relatively minor and can therefore be excluded for the purposes of the sift.

**Step 5** identifies the regulations applicable to each high-level market, beginning with FSA rules and guidance but ultimately mapping them onto the relevant FSMA provisions. The FSMA provisions are assessed against the high-level questions (Q1–Q3, depending on market type).

**Step 6** is a top-down cross-check in which all parts and sections of the FSMA are assessed against each high-level question.

**Step 7** concludes with an assessment of the FSMA provisions that have a potentially significant impact on competition, as identified in Steps 5 and 6.

## DATA SOURCES

2.22 Oxera's research was supported by the following sources of information.

- *Secondary data and public domain reports*—data was used from documents published by market research organisations, such as Datamonitor, and trade associations.
- *Investigations and reviews*—as mentioned above, in recent years a number of financial services markets have been subject to reviews by the FSA, OFT, European Commission and others. The reports of these investigations were consulted to inform the assessment of the competition and market failure indicators.
- *In-depth interviews*—between May and September 2004, Oxera conducted around 50 interviews to cover all the high-level markets as

well as general FSMA issues. In particular, we held separate in-depth discussions on each market with relevant experts from the FSA. We further obtained views and information through interviews with HM Treasury, the FOS, members of the Financial Services Consumer Panel, the FSPP, and the Small Business Practitioner Panel, all the major trade associations, some legal experts and several individual financial services firms.<sup>14</sup> Oxera is extremely grateful to all those who have assisted with the research.

2.23 Oxera has made every effort to be as comprehensive as possible in the assessment of each of the competition and risk/market failure indicators, and of the relevant regulation for each high-level market. However, the analysis in this report is largely based on secondary data sources. In some cases, use of new primary data sources might lead to different assessments of the competition indicators. Nevertheless, Oxera considers that the analysis contained in this report is sufficiently rich in detail to allow the main areas where the FSMA may have had an adverse effect on competition to be identified.

### **Structure of the report**

2.24 The remainder of this report is structured as follows.

- Section 3 gives a short overview of the results of Oxera's market analysis. A more detailed description of this analysis is provided in the appendix.
- Section 4 discusses the positive effects of the FSMA on market functioning.
- Section 5 explores the effects of the FSMA on the competitive structure of markets.
- Section 6 assesses the effects of the FSMA on the dimensions of competition.

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<sup>14</sup> The individual firms we interviewed remain anonymous. The trade associations interviewed are the London Investment Banking Association (LIBA), the Association of Private Client Investment Managers and Stockbrokers (APCIMS), the Investment Management Association (IMA), the Alternative Investment Management Association (AIMA), the British Bankers' Association (BBA), the Building Societies Association (BSA), the Association of British Insurers (ABI), the International Underwriting Association of London (IUA), the British Association of Venture Capitalists (BVCA), the Association of Independent Research Providers (AIRP), the Investors' Research Association, and the National Association of Pension Funds (NAPF).

- Section 7 discusses how the FSMA framework deals with competition issues.
- A glossary is provided at the end of the report.

### 3 OVERVIEW OF THE COMPETITION AND MARKET FAILURE ANALYSIS

#### Classification of high-level markets

3.1 Table 3.1 shows how Oxera has classified the 18 high-level markets identified for the Review, based on the detailed analysis of competition and risk/market failure indicators. (Three of these markets—deposit-taking, investment advice to institutional clients, and investment banking—have been split into segments, bringing the total to 22). A description of the results of this analysis is contained in the appendix.

TABLE 3.1 - CLASSIFICATION OF HIGH-LEVEL MARKETS

<i>High-level market</i>	<i>Competition indicators</i>	<i>Market failure/risk indicators</i>	<i>Type</i>
1a Deposit-taking services for private consumers and SMEs—current accounts	Above	Above	A
1b Deposit-taking services for private consumers and SMEs—savings accounts	Below	Above	B
2 Deposit-taking services for large business customers	Below	Below	D
3 Investment and pension advice to retail customers	Below	Above	B
4a Investment advice to institutional clients—equity research	Below	Below	D
4b Investment advice to institutional clients—credit-rating agencies	Above	Below	C
4c Investment advice to institutional clients—pension fund consultants	Above	Below	C
5a Investment banking services—IPOs	Above	Below	C
5b Investment banking services—other	Below	Below	D
6 Retail investment funds	Below	Above	B
7 Fund management services for institutional clients	Below	Below	D
8 Hedge funds	Below	Above	B
9 Brokerage and fund management services for private customers	Below	Above	B
10 Brokerage services for institutional clients	Below	Below	D
11 Trading infrastructure	Above	Above	A
12 Clearing and settlement infrastructure	Above	Above	A
13 Custody services offered to institutional customers	Above	Below	C
14 General insurance services for private consumers and SMEs (except life assurance)	Below	Above	B
15 Life assurance services for private consumers	Below	Above	B
16 Insurance services for large business customers	Below	Below	D
17 Reinsurance services	Below	Below	D
18 Insurance services provided by Lloyd's of London	Below	Below	D

## Comments on the classification

3.2 It can be seen from Table 3.1 that there are markets of all four types.

- There are three Type A markets where both competition and market failure indicators are above the threshold—current-account services offered to private and SME customers, trading infrastructure, and clearing and settlement infrastructure. In these markets, all three high-level questions are of relevance—ie, has the FSMA had an impact on market structure, on the dimensions of competition, and on market functioning?
- There are seven Type B markets in which the competition indicators are below the threshold—they are unconcentrated markets with low entry barriers—but which are characterised by significant market failures that are likely to have given rise to regulatory intervention. The key questions addressed for these markets are whether the FSMA has affected the dimensions of competition and market functioning.
- Four Type C markets have been found—credit-rating agencies, pension fund consultants, investment banking services in relation to IPOs, and custodian services offered to institutional clients. These markets are concentrated and characterised by entry barriers, but market failures are not as pervasive as in other markets, implying potentially less need for regulation in these markets. Indeed, FSMA regulation in these markets is relatively limited.<sup>15</sup>
- Finally, eight markets are of Type D, which means that both competition and market failure indicators are below the threshold, hence they are discarded at this stage of the sift. The only exception is the Lloyd's of London market, which is analysed further in the report because it is specifically dealt with in the FSMA (Chapter XIX).

3.3 An important driver of the result for the risk and market failure classifications has been the type of customer in each market. Most markets where the customers are individuals or small businesses have a market failure classification above the threshold. In contrast, many markets with institutional or large business customers are rated below the threshold (the only exceptions are hedge funds, trading infrastructure and clearing and settlement infrastructure).

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<sup>15</sup> Credit-rating agencies and pension fund consultants do not fall directly under the FSMA. They were originally included as part of the market for investment advice offered to institutional customers, but at a later stage separated from equity research.

- 3.4 This is not to say that no risks or market failures arise in these markets—indeed, they frequently do. The difference is that risks can often be appropriately contracted for between suppliers and the more sophisticated buyers. Furthermore, one of the main market failures in financial services—asymmetric information—is less significant in markets with well-informed buyers.
- 3.5 Finally, it should be reiterated that these classifications do not imply a verdict on the state of competition in each market. That is, a Type A or Type C classification does not mean that there are significant competition problems that require scrutiny; rather, it suggests that the competitive structure in these markets is such that any potential regulatory effects may be of greater concern. Likewise, a Type B or Type D classification does not imply that the market in question has been given a clean bill of health regarding potential competition concerns, just that regulation is less likely to have an adverse effect on competitive structure in these markets.



## 4 EFFECTS OF THE FSMA ON MARKET FUNCTIONING

### The need for regulation in the presence of market failures

- 4.1 A significant impact of financial services regulation is that it improves how markets function by addressing market failures. The market analysis carried out by Oxera confirms that there are significant market failures in a large number of markets in the financial services sector. The main failures are systemic risk (combined with negative externalities)—in particular in the high-level markets for deposit-taking, hedge funds, and clearing and settlement infrastructure—and asymmetric information between buyers and sellers, which exists in almost all retail markets but also in some institutional markets, such as investment advice.
- 4.2 The FSMA provides for a framework in which the FSA is given the responsibility and powers to deal with market failures. These powers include the following.
- *Authorisation and supervision regime*—to achieve its objectives, the FSMA gives the FSA the role of gatekeeper to ensure that firms (and individuals) undertaking regulated activities are fit and proper to perform the roles applied for. Firms that are granted authorisation have to ensure that they satisfy the authorisation requirements on a continuing basis. The FSMA also gives the FSA the powers to supervise financial institutions, with the aim to protect consumers who are exposed to financial/default and systemic risks in these markets. The financial institutions themselves also benefit from supervision as it contributes to confidence in markets in which they operate.
  - *Business conduct*—the market analysis shows that there is asymmetric information between suppliers and consumers in a large number of markets. This means that product offerings are non-transparent or diverse, and consumers are not sophisticated or informed. A clear example is the market for retail advice. In addition, in some markets there is asymmetric information regarding the quality or performance of the product or providers. This sometimes even arises in markets where customers are more sophisticated, for example in the market for fund management services offered to institutional investors. The FSA Conduct of Business Sourcebook contains rules, provisions and guidance governing a firm's relationship with its customers. It includes rules on the terms of business and client agreements, financial promotion, advising and selling, conflict of interest, and dealing and managing, thereby protecting consumers against misconduct by financial services firms and enhancing transparency and disclosure.

- *Market misconduct*—Section 119 of the FSMA requires the FSA to produce a code on market conduct. The FSA Code of Market Conduct describes what does and does not amount to market abuse, and deals with issues such as misuse of information and false or misleading statements and practices. These principles will contribute to market confidence. Given that retail consumers do not, in general, have the expertise to assess the performance and reliability of financial service providers, rules on market conduct are necessary to create market confidence and make markets function properly.

### **Redress mechanisms (FSCS and FOS)**

- 4.3 The FSMA further provides two important mechanisms of redress for consumers wishing to complain or seek compensation for losses incurred as a result of the actions of authorised firms: through the Financial Ombudsman Service (FOS) and the Financial Services Compensation Scheme (FSCS). The function of the FOS is to resolve disputes between consumers and financial services firms. The FSCS acts as a fund of last resort for customers of authorised firms. Like the FOS, its primary aim is to provide protection for private individuals and small businesses. The FSCS can pay compensation if a firm is unable, or likely to be unable, to pay claims against the firm, usually because it has gone out of business or is insolvent. Both the FOS and FSCS attained their powers under the FSMA, replacing several predecessor redress bodies, and have since seen a large and increasing volume of activity. This activity is funded by levies imposed on regulated firms.
- 4.4 Industry bodies have expressed some concerns about the costs imposed on the firms by the redress bodies. However, these seem small compared with other costs imposed by the regulatory system. Such costs are unlikely to have a significant impact on the competitive structure or nature of competition in the market. Specific concerns have been raised about the wider implications for firms of the decisions of the FOS and its interpretation of FSA rules.<sup>16</sup> The operation of the FOS and its relationship with the FSA are examined separately as part of the wider FSMA Review, and are therefore not addressed further in this report. In terms of the impact on competition, the FOS and FSCS mainly have an indirect, positive effect—giving customers access to redress can increase confidence in the system and thereby promote the operation of the market.

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<sup>16</sup> See, for example, the statement of the FSPP (2003), 'HM Treasury N2 Plus 2 Review'.

## Conclusion

- 4.5 It is important to recognise the positive role of financial services regulation in dealing with market failures and improving how markets function in the first place. As is generally known, and has been confirmed by Oxera's market analysis, many financial services markets are characterised by pervasive market failures.
- 4.6 The four regulatory objectives established in Section 2(2) of the FSMA—market confidence, public awareness, consumer protection, and reduction of financial crime—all relate to market failures. The FSMA also establishes the general mechanisms for the FSA to address market failures, in particular the authorisation regime, prudential regulation, the conduct of business regime and the market-abuse regime. It also establishes two redress mechanisms, the FSCS (Part XV) and the FOS (Part XVI), which seek to enhance market confidence and protect consumers.
- 4.7 An important conclusion of the FSMA Competition Review, therefore, is that the FSMA (and financial services regulation in general) is likely to have a positive effect on competition by improving how markets work.

## 5 EFFECTS OF THE FSMA ON MARKET STRUCTURE

5.1 The first high-level question that Oxera addressed is whether the FSMA has unduly distorted the competitive structure of markets. Regulation may restrict entry directly through the authorisation regime, but also indirectly through ongoing regulatory capital and other requirements on firms. The question is not whether entry is restricted per se (under the authorisation regime it is), but whether such restrictions are significant relative to total market size. If a large number of suppliers compete in the market, this is one indication that the regulatory barrier has not had a significant impact. Furthermore, the question is whether the impact is 'unduly' affecting the competitive structure of a particular market. Even if regulatory entry barriers are found to be significant, they may be justified if they address an underlying market failure (in line with the four regulatory objectives set out in the FSMA).

### The authorisation and recognition regime

5.2 Parts II, III and IV of the FSMA establish the authorisation regime. Section 19 of the FSMA states that firms undertaking a regulated activity in the UK must be authorised or exempt. The regulated activities are listed in the Regulated Activities Order 2001.<sup>17</sup> Conducting unauthorised regulated activities is a criminal offence. There are three main routes to authorisation: the FSA, passport rights, and Treaty rights (see below). In addition, there is a recognition regime for investment exchanges and clearing houses.

#### AUTHORISATION BY THE FSA

5.3 The FSMA sets out threshold conditions that a firm must satisfy to obtain and retain FSA authorisation, including the following.

- *Legal status*—applications for permission may be made by individuals, companies, partnerships or unincorporated associations. However, deposit-taking activities can only be carried out by a body corporate or a partnership, and insurance activities by a body corporate, a registered friendly society or a member of Lloyd's.
- *Location of offices*—a UK company applying for authorisation must have its registered office and head office in the UK. This is to ensure that the FSA is able to monitor and control the authorised firm effectively.
- *Close links*—if a firm has close links with another company, the FSA must be satisfied that these links are not likely to prevent effective

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<sup>17</sup> FSMA 2000 (Regulated Activities) Order 2001, SI 2001/544.

supervision. Close links are defined in company law terms and include parent, subsidiary and sister companies.

- *Adequate resources*—a firm must have adequate resources in relation to its regulated activities, including human and capital resources, and risk management.
- *Suitability*—this is a rather broadly defined condition. A firm must be able to show that it is fit and proper and that its affairs are conducted soundly and prudently.

- 5.4 Furthermore, Section 59 of the FSMA states that individuals who are performing a controlled function within an authorised firm, such as a chief executive or director, finance officer or risk assessment officer, must be approved by the FSA. Key individuals within the firm are vetted by the FSA to ensure they are fit and proper.
- 5.5 The threshold conditions for authorisation are the same for all financial services firms, but the information required to obtain permission from the FSA and the way firms are supervised after they have been authorised varies depending on the risk assessment that the FSA applies to the firm. The FSA seeks to prioritise its supervisory activities by categorising firms in relation to the risk they pose to the FSA's statutory objectives. The risk a firm poses depends on the potential impact on the FSA's statutory objectives if the risk in question actually materialises, and on the probability that it will materialise. High-risk firms must provide very detailed information during the authorisation process and are monitored closely by the FSA after authorisation; by contrast, low-risk firms need to provide less sophisticated material during the authorisation process and are supervised with a lighter touch after the authorisation.
- 5.6 The risk a firm poses depends not only on its type of business and customers (ie, whether it provides services to retail or institutional clients), but also on the way it meets the threshold conditions. The FSA retains some flexibility with regard to decisions on applications. For example, if the authorisation assessment indicates that certain threshold conditions have only just been met, the firm may still be authorised, but will be monitored more closely after authorisation.
- 5.7 Section 52 of the FSMA states that, starting from the date the application is received, the FSA has six months to determine a complete application.<sup>18</sup> Section

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<sup>18</sup> For an incomplete application, the FSA must determine the application within the earlier of (a) six months from the date the FSA received a completed application, or (b) 12

61 of the FSMA provides the FSA with three months in which to process applications for approved-person status.<sup>19</sup> The FSMA gives the FSA legal limits for completing applications, although, in practice, the FSA endeavours to complete applications more quickly. For example, the FSA's updated service standards indicate that 70% of corporate authorisations will be completed within four months of receipt, while 85% of applications for approved-person status will be completed within two, four, or seven days, depending on the type of application.<sup>20</sup>

5.8 In a survey undertaken by the FSPP in 2002 among regulated firms, around two-thirds of chief executives and heads of compliance who gave an opinion indicated that the FSA operates a 'straightforward authorisation period'.<sup>21</sup> Smaller organisations were the least positive about the FSA's approach—only half of those who gave an opinion agreed that the FSA operates a 'straightforward authorisation period'.

5.9 Table 5.1 shows that 900 firms were authorised during the year 2003/04. 86 firms withdrew their application during the process.

TABLE 5.1 – NUMBER OF AUTHORISED FIRMS

	<i>Number of firms</i>
Balance at March 31st 2003	11,304
Authorised in 2003/04	900
Cancelled in 2003/04	1,492
Balance as at March 31st 2004	10,712

Source: FSA Annual Report 2003/04.

#### PASSPORT RIGHTS AND TREATY RIGHTS

5.10 Passport rights allow a firm authorised under the law of one Member State in the European Economic Area (EEA) to open a branch or sell cross-border into another EEA state, without the need to obtain further authorisation from that state. EC Directives, which have been transposed into national law, give passport rights to several types of financial services firms, including banks,

months of receipt of the incomplete application. If information requested in the application pack is outstanding, the application will be considered incomplete.

<sup>19</sup> If, during this time, the FSA contacts the firm making the application for information, the deadline is extended by the number of days the firm takes to respond to the FSA's request.

<sup>20</sup> FSA services standards: [http://www.fsa.gov.uk/what/service\\_standards.html](http://www.fsa.gov.uk/what/service_standards.html)

<sup>21</sup> FSPP (2002), '2002 Survey of the FSA's Regulatory Performance', November, report prepared by BMRB Social Research.

investment firms, life and non-life insurance business and collective investment schemes (CIS). For activities not covered by passport rights, firms may be able to invoke the EC Treaty in accordance with Section 31 of the FSMA. Treaty rights are similar to passport rights but are established by case law rather than through EC Directives.

- 5.11 When a firm is entering the UK using passport rights, the regulator in the firm's home country retains full responsibility for authorising the firm and for prudential supervision. The FSA may impose rules relating to the firm's dealings with clients in the UK (ie, Conduct of Business rules).

#### RECOGNITION REGIME

- 5.12 The FSMA provides that recognised investment exchanges (RIEs), recognised clearing houses (RCHs) and certain other categories of exchange are exempt and are not required to apply for authorisation. The requirements that must be satisfied before an investment exchange or clearing house can be recognised are set out in regulations made by HM Treasury.<sup>22</sup> For example, they must have financial resources to properly perform their functions, be fit and proper, and have adequate systems and controls. Overseas exchanges and clearing houses may also apply for recognition and will be exempt in relation to regulated activities that they carry out in the UK as an exchange or clearing house.

#### Effects on entry in Type A and Type C markets

- 5.13 The effects of the FSMA on competitive structure have been assessed for the Type A and Type C markets (see Table 3.1).

#### TRADING INFRASTRUCTURE AND CLEARING AND SETTLEMENT INFRASTRUCTURE

- 5.14 Two of the Type A markets—trading infrastructure and clearing and settlement infrastructure—have specific provisions in Part XVIII of the FSMA. This part deals with RIEs and RCHs. Under Part XVIII, these recognised bodies are exempt from the authorisation requirements. Instead, they must meet the recognition requirements, as referred to in the above sub-section.
- 5.15 It is unlikely that these requirements constitute a significant barrier to entry. In relation to trading infrastructure, the FSA has informed Oxera that it has not had to decline any applications for RIE status since the introduction of FSMA. Furthermore, trading platforms can opt to become an authorised person under

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<sup>22</sup> FSMA 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001, SI 2001/995.

the FSMA, rather than seeking RIE status (the requirements for which are quite similar in practice). Indeed, the two UK RIEs offering trading in equity—LSE and virt-x—are in direct competition with alternative trading platforms that operate as authorised firms. Finally, the major UK RIEs—the LSE, LIFFE (part of Euronext.liffe), the LME and the IPE—compete to a large degree with overseas exchanges as well, further limiting the potential impact of the FSMA on entry.

- 5.16 With regard to RCHs, the reason why there are only two—LCH.Clearnet and CREST (part of Euroclear)—is also not because of any regulatory entry barrier; rather, it is due to the nature of their activities, which are characterised by strong economies of scale and network effects, and could be considered natural monopolies.<sup>23</sup> The treatment of RIEs and RCHs under the FSMA is also discussed in section 7 of this report.

#### CURRENT ACCOUNTS OFFERED TO PRIVATE CONSUMERS AND SMEs

- 5.17 The market for current-account services offered to private customers and SMEs is relatively concentrated (although much less than the other two Type A markets discussed above), with a Hirschmann–Herfindahl index (HHI)<sup>24</sup> of around 1,500, which is roughly equivalent to having six equal-sized firms in the market). There are some indications that this degree of concentration is due to factors other than regulation, but it is not possible to draw definite conclusions.
- 5.18 By virtue of Section 22 of the FSMA and Article 5 of the Regulated Activities Order 2001, deposit-taking is specified as a regulated activity. There are also specific capital requirements that apply to banks, as detailed in the Integrated Prudential Sourcebook (which is based on EC Directives rather than the FSMA).
- 5.19 However, one indication that regulatory capital requirements may not constitute a significant entry barrier is that, in general, UK banks and building societies hold capital in excess of the regulatory requirements. This is particularly the case for smaller banks (for which the concern about entry barriers would be

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<sup>23</sup> See Niels, G., Barnes, F. and van Dijk, R. (2003), 'Unclear and Unsettled: The Debate on Competition and Regulation in Clearing and Settlement of Securities Trades', *European Competition Law Review*, **24**, 634–9.

<sup>24</sup> The HHI is the sum of the squares of each firm's market share. For example, in a market with five firms that each have a share of 20%, the HHI would be  $400 + 400 + 400 + 400 + 400 = 2,000$ . The HHI ranges between 0 (a very large number of very small firms) and 10,000 (one firm with 100% market share). As described in more detail in the Stage 1 report, Oxera has followed the criteria often used by competition authorities in interpreting the HHI. Essentially, an HHI above 1,800 is considered high and below 1,000 considered low. See Oxera (2004), 'Review of the Impact of the Financial Services and Markets Act 2000 on Competition', report prepared for the OFT, OFT 714, March.



greater than for larger banks). A study by Alfon, Argimon and Bascunana-Ambros (2004) suggests that UK banks hold an unweighted average buffer over required capital of 250%.<sup>25</sup>

- 5.20 The concentrated nature of the market is partly explained by non-regulatory factors such as economies of scale and the existence of branch networks. The established market participants all have extensive branch networks that are likely to constitute a barrier to entrants. To illustrate, recent entry has mainly been through building societies that already have a branch network, or confined to the market for savings accounts, for which branches are less important (several entrants offer Internet-only savings accounts).
- 5.21 One group of new players in deposit-taking—the large UK supermarkets—entered through joint ventures with existing banks, rather than independently. It is not clear to what extent this has been due to commercial realities or to regulatory requirements. The supermarkets already have a 'branch' network, so this did not constitute a barrier to enter independently. Another reason may have been the required investment in the appropriate systems and controls. The supermarkets' comparative advantage lies in the distribution of the products, so entering the market as a joint venture with an existing bank that is in charge of the systems and controls seems to make business sense.
- 5.22 Regulation may also have played a role in this regard. The Integrated Prudential Sourcebook makes the bank's directors and management responsible for establishing and maintaining systems and controls. As such, outsourcing of these systems and controls would be less attractive for a supermarket that entered independently as a bank. Nevertheless, given the high degree of systemic and operational risk in deposit-taking, the requirements in the Integrated Prudential Sourcebook do not seem unreasonable.

#### THE FOUR TYPE C MARKETS

- 5.23 In the four Type C markets, the high level of concentration is also unlikely to be due to the UK regulatory framework. In relation to the markets for advice from credit-rating agencies and pension fund consultants, these are not considered regulated activities and hence do not fall under the authorisation regime. For the services offered by investment banks (particularly in relation to IPOs) and custodian banks, regulation does not constitute a significant entry barrier either. For example, the fact that many foreign investment banks (both US and European) have been able to enter the UK market suggests that regulatory

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<sup>25</sup> Alfon I., Argimon, I. and Bascunana-Ambros, P. (2004), 'What Determines How Much Capital is Held by UK Banks and Building Societies?', *FSA Occasional Paper Series*, 22.

requirements are not an obstacle. Instead, there are other factors that may explain concentration in each of these Type C markets.

- 5.24 For credit-rating agencies there is a regulatory entry barrier, but one that is not UK-specific—global standards are to some extent set by the US designation of 'Nationally Recognised Statistical Ratings Organisation', which so far has been accorded to only four firms (Standard & Poor's, Moody's, Fitch, and Dominion Bond Rating Services). Of these, the first three are the only global players, and dominate the credit-rating market. Other entry barriers in this market may include economies of scale and the reputation of the existing firms.
- 5.25 In the markets for pension fund consultants and for IPOs, the level of concentration is also likely to be due to a combination of economies of scale and reputation effects. For example, uncertainty about the success of an IPO and the potential damage of an IPO failure tend to make companies select investment bankers with significant experience and reputation. In addition, access to a large-scale network of potential sellers and buyers is crucial since the essence of investment banks' activities is to bring together buyers and sellers. Similarly, the most important entry barrier in the market for pension fund consultants, in addition to a minimum efficient scale, appears to be the strong brands built up by the leading firms within the industry, and their long track record.
- 5.26 Finally, the custody market—which is global in nature—is moderately concentrated at present, with an HHI below 1,000. However, the trend is towards increasing consolidation. The top four global custodians (State Street, Bank of New York, JP Morgan and Citigroup) already account for almost 60% of assets in custody worldwide.<sup>26</sup> Entry barriers are significant, due to the following factors: economies of scale; the need for access to central securities depositories (CSDs) in many countries, either directly or through local agents; and the need for sophisticated systems dealing with the operational risks inherent in the custody of assets.
- 5.27 Regulation has little influence on this trend towards consolidation in the custody market. In this respect, it is important to note that the UK market is fully open to global custodians, of which only HSBC is a UK-domiciled company. In contrast, in some EU Member States, entry is restricted by regulations that limit access to the national CSD to local banks, leading to the need to use local sub-custodians in those countries.<sup>27</sup> This is not an issue in the UK.

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<sup>26</sup> Source: [www.globalcustody.net](http://www.globalcustody.net).

<sup>27</sup> See Giovannini Group (2003), 'Second Report on EU Clearing and Settlement Arrangements', August. The European Commission has proposed a Framework Directive

## Impact on horizontal or vertical structure

- 5.28 Regulation may also distort competitive structure by imposing (directly or indirectly) a certain horizontal or vertical structure that may not necessarily be the most competitive one. For example, regulation may, explicitly or implicitly, drive firms towards horizontal consolidation, or it may force firms to separate certain activities vertically.

### DIRECT FSMA EFFECTS

- 5.29 One area where the FSMA has changed the vertical structure of markets is the market for trading infrastructure, specifically in relation to the listing of securities. Part VI of the FSMA moved some of the regulatory functions related to the official listing of securities from the LSE to the FSA, which is now the 'competent authority' and performs these functions as the UK Listing Authority (UKLA).
- 5.30 While this change has had an impact on the vertical structure of the trading infrastructure market (specifically with respect to equity trading), this is unlikely to distort competition. Rather, from an economics perspective, the change sets a clearer boundary between government regulation and the functions carried out by the LSE, which, apart from regulating its markets (which it does as an RIE), also has a commercial imperative and is in competition with other exchanges. The effect is likely to be pro-competitive, and is further discussed in section 7.

### INDIRECT FSMA EFFECTS

- 5.31 One area where regulation may have affected the vertical structure is the market for advice to retail consumers, where the polarisation regime imposes specific rules on the vertical relationships between financial advisers and suppliers of financial products (this regime is about to change—see below). An important element of protection in the polarised regime has become known as the 'better than best' rule. This is a standard of suitability that requires an independent adviser to recommend the products of a connected provider only where it can be demonstrated that they are more suitable than any other suitable packaged product generally available.
- 5.32 In effect, this standard of suitability has prevented advisers from recommending the products of connected firms, and, in turn, this has discouraged integration

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to deal with the issue of access to clearing and settlement systems. See European Commission (2004), 'Clearing and Settlement in the European Union—The Way Forward', Communication to the Council and Parliament, COM(2004)312, April 28th, and also section 7 of this report.

between product providers and independent intermediaries. This means that the polarisation regime divides firms that sell financial products such as life assurance, CIS and investment trust saving schemes into two categories: an independent financial adviser (IFA), who acts as an agent for and advises the customer; and a representative, in the form of an agent of the company, selling on behalf of a single company (or group) and restricted to selling that company's (or group's) products, with the company taking responsibility for the activities of its representative. In practice, the regime does not allow for multi-tied advisers—ie, advisers with (financial) links with several companies.

- 5.33 The concept of polarisation, introduced through rules made by the Securities and Investment Board (SIB) under the powers contained in the Financial Services Act 1986, was developed to deal with perceived abuses in the market prevalent at the time. These included the payment of extra commissions in return for higher levels of business written and the lending of opaque interest-free 'loans' by product providers to intermediaries. These loans, by mutual consent, were never repaid provided that the levels of business written stayed above agreed levels. Such practices could make advisers place their own interest before that of consumers. By making a clear distinction between IFAs and tied agents, the polarisation regime intended to simplify the options for consumers, thereby improving market functioning.
- 5.34 The OFT reviewed the rules made by SIB in 1987 before they were implemented, and decided that they were significantly anti-competitive in their effect.<sup>28</sup> Nevertheless, the polarisation regime was implemented. The OFT kept the rules under review and produced a further report in 1999,<sup>29</sup> concluding that the rules were still anti-competitive in their effect. In particular, downstream polarisation was found to restrict and distort competition between distribution channels by banning all business models, other than distribution through tied agents and IFAs, thereby restricting innovation in retailing formats and reducing the degree of competition between product providers (and hence products) selling through the tied channel. Upstream, the polarisation regime was assessed as having the potential to form an entry barrier for providers, by creating an asymmetry between the providers that already have tied advisers, and those that do not; and by preventing competition between different providers within a tied adviser.

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<sup>28</sup> OFT (1987), 'Securities and Investments Board: A Report by the Director General of Fair Trading to the Secretary of State for Trade and Industry', March.

<sup>29</sup> OFT (1999), 'The Rules on Polarisation of Investment Advice', August.

5.35 The FSA decided to change the regime to one of depolarisation, following two consultation papers published in 2002 and 2003, respectively.<sup>30</sup> Under depolarisation, financial advisers will be allowed to be multi-tied. Firms will be able to select from a range of products from any number of providers, and that range can be as wide or narrow as firms choose. The better-than-best rule will also be abolished. A key part of the new regime will be disclosure to inform consumers of the scope of the advice on offer to them, as well as significant relationships held by the adviser and the cost of any advice provided. The general rule on inducements will continue to apply and will be extended to multi-ties.

### **Authorisation and compliance costs as entry barriers**

5.36 By definition, any regulation imposes certain compliance costs on the industry, and, if significant, these may constitute a barrier to entry. This could be of particular concern if it has a differential impact on smaller and larger firms, disadvantaging the former because of their scale.

5.37 In line with the sifting methodology, the impact of the FSMA on market structure would be of greatest concern in the Type A and Type C markets. As explained above, such regulatory impact on these markets is likely to be limited. However, the research undertaken suggests that authorisation and compliance costs hinder the entry of smaller firms to some extent in Type B markets. While these markets are unconcentrated and often have tens or hundreds of different suppliers (which means that overall competition is unlikely to be distorted significantly), it is worth exploring the issue further.

5.38 With respect to authorisation costs, there is little information in the public domain. Evidence on the effect of the authorisation regime is therefore of an anecdotal nature, resulting from interviews with many parties. It has been put to Oxera that the authorisation requirements and processes may have prevented new companies, in particular smaller ones, from entering certain markets, such as that for private client wealth management. Given the large number of parties in this market, this is unlikely to have had a significant effect on competitive structure (although it may potentially affect entry at the margin).

5.39 Furthermore, there is anecdotal evidence that some UK insurance companies decided to obtain authorisation in Ireland (by moving their official location to Dublin) because they felt that the authorisation process in the UK was too slow. Although it is unlikely that this has affected the degree of competition in the UK

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<sup>30</sup> FSA (2002), 'Reforming Polarisation: Making the Market Work for Consumers', Consultation Paper 121, January; and FSA (2003), 'Reforming Polarisation: Removing Barriers to Choice', Consultation Paper 166, January.

market, since these companies continued to supply their services in the UK, it may be indicative of some companies considering the costs of authorisation too high. The decision to seek authorisation in Dublin may also have been driven partly by taxation and differences in approach to the ongoing regulation of reinsurance between London and Dublin. In addition, the average time for authorisation of insurance companies has fallen to 17–20 weeks, whereas several years ago this was more than 52 weeks.<sup>31</sup>

- 5.40 With respect to ongoing compliance costs, these may distort competition by imposing more costs on some companies than others. A recent report for the FSA estimated the ongoing costs of compliance with FSA rules and monitoring against the counterfactual that there were no FSA rules or monitoring.<sup>32</sup> The sample of companies, which included both large and small firms across the range of activities covered by FSA rules, reported a median incremental compliance cost of 1.6% of non-regulatory operating costs. At a disaggregated level, the report found that larger firms and those that faced significant overseas regulation reported proportionally smaller incremental costs of compliance—the median incremental cost was 3%, 2%, and 1% for small, medium-sized and large companies respectively. This finding is consistent with a survey undertaken on behalf of the FSPP in which smaller firms report higher compliance costs than larger firms.<sup>33</sup>
- 5.41 Thus, there is some potential for financial services regulation to favour medium-sized and larger firms, which might lead to consolidation of firms. However, the overall effect on competition in financial services markets is unlikely to be significantly negative. Furthermore, authorisation costs need to be considered in the context of other (non-regulatory) start-up costs that firms face when entering new markets. Authorisation costs may only be a small part of total start-up costs.

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<sup>31</sup> FSA (2004), General Insurance Sector Newsletter, September.

<sup>32</sup> FSA (2003), 'Cost of Compliance: A Report by Europe Economics'.

<sup>33</sup> FSPP (2002), '2002 Survey of the FSA's Regulatory Performance', November, report prepared by BMRB Social Research. The level of compliance costs estimated in this survey is higher than in the FSA study—about half of respondents believed their costs of compliance were between 2% and 10%. The difference in cost levels may be due to the fact that the FSPP survey did not include a clearly defined counterfactual, and respondents may have envisaged a range of counterfactuals different from that specified in the Europe Economics survey.

## Conclusion

- 5.42 Oxera concludes that the FSMA itself is unlikely to have had, or to have, any significant adverse effects on the competitive structure of markets.
- 5.43 The main mechanism through which such effects might have arisen is the authorisation (and recognition) regime, since this constitutes a regulatory barrier to entry. However, the market analysis carried out by Oxera suggests that the regime has not acted as a significant entry barrier in any of the Type A and Type C markets (current accounts, trading infrastructure, clearing and settlement infrastructure, credit-rating agencies, pension fund consultants, IPOs and custody). Rather, the relatively high degree of concentration and entry barriers in these markets can be attributed to other factors, such as economies of scale, network effects and reputation effects.
- 5.44 The FSMA has had a direct impact on vertical structure in one high-level market—trading infrastructure—by giving the FSA responsibility for some of the regulatory functions previously carried out by the LSE—ie, the functions the FSA currently carries out as the UKLA. As explained in this section, the effect is likely to be pro-competitive. From an economics perspective, this change sets a clearer boundary between government regulation and the LSE, which, besides its regulatory functions, has a commercial imperative and competes with other trading platforms.
- 5.45 Finally, the FSMA, and the statutory instruments and FSA rules to which it gives rise, create regulatory compliance costs to firms, and the evidence suggests that this affects smaller firms more than medium-sized and larger firms. This may deter some small firms from entering the market and may have led to consolidation of firms. However, the overall effect on competition is unlikely to be significantly negative, in particular because the high-level markets in which these effects are felt have in general been classified at Type B or Type D, which means that overall concentration and entry barriers are low.

## **6 EFFECTS OF THE FSMA ON THE DIMENSIONS OF COMPETITION**

- 6.1 The second high-level question (which was addressed for Type A, B and C markets) is whether the FSMA has affected the dimensions of competition. For example, regulation may restrict the types of product characteristics that can be offered, may impose behavioural restrictions on firms, and may have an impact on innovation such as improvements in production/service technology or the introduction of new products. Regulation may also distort competition by imposing differential regulation on products considered substitutes by consumers (to the extent that such differences are not justified by the underlying characteristics of the products).

### **Direct impact of the FSMA**

- 6.2 As discussed above, the FSMA sets out only a general regulatory framework for financial services. This means that the behaviour of firms is largely influenced by specific FSA rules rather than by the FSMA itself. Nevertheless, Oxera's market analysis identifies one case in which the FSMA may have had a direct effect on the dimensions of competition. This is in relation to collective investment schemes (CIS), which are specifically addressed in Part XVII of the FSMA, but which also compete to some extent with other types of retail investment funds that are regulated differently.
- 6.3 Oxera classified the high-level market for the provision and management of retail investment funds as a Type B market. There are more than 100 fund management firms supplying these services, and entry barriers are relatively low. Different types of retail funds, such as unit trusts, investment companies with variable capital (ICVCs), investment trusts and unit-linked life funds compete with each other to some extent.
- 6.4 Unit trusts are investment funds established by unit trust managers in the form of trusts to manage, on behalf of investors, a portfolio of securities, or other types of assets, such as deposits, money market instruments, and derivatives. Open-ended investment companies (OEICs) are corporate funds set up as special purpose vehicles with an exclusive objective of investing funds to the benefit of their investors. Since 2001, these have become known as ICVCs. Unit trusts and ICVCs are both open-ended funds—ie, funds whose capital can normally be increased or decreased by their managing body (unit trust manager or ICVC directors) through repurchase or issue of units or shares. Investment trusts are closed-ended investment companies that issue shares to investors and invest the proceeds in a portfolio of securities of other companies. Unlike



open-ended CIS, the number of shares a trust issues, and therefore the capitalisation of the trust, is fixed from the start.

- 6.5 CIS are covered by Part XVII of the FSMA, but the definition of collective investments covers only unit trusts (those authorised for sale to retail customers) and ICVCs. Correspondingly, FSA product regulation is restricted to these funds and excludes investment trusts and unit-linked life funds. For example, while unit trusts and ICVCs are subject to investment and borrowing restrictions, investment trusts have more flexibility in their investment decisions and have extensive abilities to borrow, subject to the approval of the trust's board of directors. While the providers of life funds are regulated (eg, they must comply with prudential regulation of insurance companies and Conduct of Business rules), the funds themselves are not subject to specific FSA product regulation. Investment trusts come under company law and the FSA Listing Rules.
- 6.6 CIS regulation also distinguishes between unit trusts and ICVCs. Although the main rules in the CIS Sourcebook apply equally to unit trusts and ICVCs, there remain some differences in their regulatory treatment—for example, in relation to charges and performance fees and to available classes of units or shares. The FSMA itself also distinguishes, at least formally, between the two types of fund—ie, FSA rule-making powers on unit trusts are dealt with in primary legislation, whereas secondary legislation deals with ICVCs.
- 6.7 These rules are detailed in the CIS Sourcebook (updated by the new sourcebook (COLL) which was introduced in April 2004 and sets rules that become compulsory in February 2007), but the FSMA gives the FSA specific powers in relation to unit trust schemes to make rules for 'restricting or regulating the investment and borrowing powers exercisable in relation to the scheme' and for 'the issue and redemption of the units under the scheme'. These powers are extended to ICVCs in the Open-ended Investment Companies Regulations 2001.
- 6.8 Differential regulation may be justified, depending on the market failures and risks associated with the products. For example, the difference in regulation between unit trusts and unit-linked life funds may be justified by the difference in risks associated with these products. In the case of life assurance products, the money is invested and held by the insurer, which, for some types of policy guarantees a certain minimum payout at a particular point in time—no such guarantee is given in the case of unit trusts, for example. To prevent the insurer from becoming insolvent, sufficient capital requirements may need to be imposed.

6.9 In recognising that the current regime may not strike the optimal balance, the FSA put forward proposals for reforming the regulation of CIS.<sup>34</sup> Under the new regime, retail investors would have access to a wider range of investment opportunities and product features through better information about the progress of their investments and through the easing of some restraints on fund managers to allow greater flexibility in the design and operation of funds. In addition, under the new proposals, the unit trust and ICVC rules would be more closely aligned.

### **Indirect impact through FSA rules**

6.10 The FSMA gives the FSA considerable discretion in how it pursues its objectives. This means that, even if the FSMA has not had any significant direct effects on the dimensions of competition, it may still have done so indirectly through the rules issued by the FSA.

6.11 It is beyond the scope of this research to assess in detail the impact of FSA rules on the dimensions of competition. By way of illustration, this section provides some examples of how regulation could have an impact on competition.

6.12 First, there may be instances of different rules being applied to different types of institutions providing similar products in the same market (as in the case of retail funds discussed in the above sub-section). The regulation applied to building societies is an example, although not directly attributable to the FSA rules. Both banks and building societies provide deposit-taking services for consumers and are therefore active in the same market. Banks and building societies are regulated in a similar way, but there are differences. For example, the latter are required to obtain 50% of their funds from members and hold 75% of business assets as residential mortgages.<sup>35</sup> Although these differences are few and may be removed in the near future, this could, in theory, affect competition between banks and building societies. The rules for building societies are based on provisions in the Building Society Act 1986 rather than the FSMA.

6.13 Second, regulation may have had an impact on innovation. This impact is difficult to measure since it requires assumptions regarding the counterfactual: how much innovation would have occurred in the absence of the existing regulation? In some cases, however, it may be possible to assess the impact of

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<sup>34</sup> FSA (2003), 'The CIS Sourcebook—A New Approach', Consultation Paper 185, May.

<sup>35</sup> FSA (2001), 'The Interim Prudential Sourcebook for Building Societies', Volume 1 (6.1.2 G).

regulation on innovation by analysing how regulation has affected firms' opportunities and their incentives.

- 6.14 An example can be found in the market for advice to retail consumers. As explained in section 5, the polarisation regime was criticised by the OFT (and is about to be changed by the FSA). In particular, it was found to restrict innovation in retailing formats and to reduce the degree of competition between product providers (and hence products) selling through the tied channel.

### **International competitiveness**

- 6.15 The FSMA Competition Review focuses on the effects of the FSMA on UK markets. From the perspective of retail consumers, most markets are indeed primarily national, in that they normally use service providers established in the UK. However, the UK financial services industry has strong international links, with many of the firms operating in the UK being part of a multinational, and often foreign-owned, institution. In addition, the Oxera market analysis shows that, in various institutional and wholesale markets (for example, institutional fund management, brokerage, trading and custody, and wholesale insurance and banking services), the geographic dimension of the market stretches beyond the UK.
- 6.16 In this respect, the FSMA could, in theory, have an effect on competition (either positive or negative) in these international markets by imposing UK-specific regulation. Oxera did not investigate this issue. However, several market participants have expressed some concerns in this regard. In particular, some perceive that UK regulation is more stringent in the UK than elsewhere.<sup>36</sup>
- 6.17 A specific issue related to international competitiveness mentioned by market participants and trade associations is the way in which EC Directives are transposed into national law and regulation. The perception is that, on some occasions, UK authorities have implemented EC Directives differently than other European countries, with the result that there are more extensive requirements placed on UK firms (a practice referred to as 'gold-plating').

### **Conclusion**

- 6.18 The FSMA sets out only a general regulatory framework for financial services. This means that the behaviour of firms is largely influenced by specific FSA rules rather than by the FSMA itself. One exception is in the market for the

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<sup>36</sup> It should be borne in mind that, in practice, the effect of more stringent regulation may also be positive. It may increase market confidence, thereby potentially making it easier for UK companies to sell their products in the international market.

provision and management of retail funds, where the FSMA creates some differential regulation by addressing certain types of funds (CIS) directly in the FMSA (Part XVII), but not other types that compete to some extent in the same market. The effect on competition may be limited, however, because this market has been classified as Type B.

- 6.19 The FSA rules and decisions may have a more direct impact on the dimensions of competition. Assessing these effects in detail is outside the scope of the FSMA Competition Review. Here, Oxera notes only that potential adverse effects on competition may arise from FSA rules, as the FSMA gives the FSA considerable discretion in setting and enforcing these rules. This underlines the importance of the competition scrutiny mechanisms that are established in the FSMA to prevent or limit such adverse effects. These scrutiny mechanisms are discussed in the next section.
- 6.20 Finally, it is noted that the FSMA Competition Review focuses on UK markets, whereas the Oxera market analysis shows that, in some institutional and wholesale markets (for example, institutional fund management, brokerage, trading and custody, and wholesale insurance and banking services), UK firms compete with overseas suppliers as well. In this respect, the FSMA could, in theory, have an effect on competition (either positive or negative) by imposing UK-specific regulation, and several market participants have expressed some concern about this. Oxera did not investigate this issue further.

## 7 ADDRESSING COMPETITION CONCERNS UNDER THE FSMA FRAMEWORK

### Competition scrutiny under the FSMA

7.1 As explained in section 6, the FSMA sets out a general framework for financial services regulation and gives the FSA considerable discretion in how it pursues the four objectives established in Section 2(2) of the FSMA (market confidence, public awareness, consumer protection and reduction of financial crime). The promotion or protection of competition is not among these primary objectives. There is therefore potential scope for arriving at sub-optimal outcomes from a competition standpoint. The FSMA contains various mechanisms aimed at preventing such sub-optimal outcomes.

#### CONSIDERATION OF COMPETITION BY THE FSA

7.2 As noted in section 2 above, the FSMA (Section 2(3)) requires the FSA to have regard to 'the need to minimise the adverse effects on competition' that may arise from its actions, to 'the desirability of facilitating competition between those who are subject to any form of regulation by the FSA', and also to 'the desirability of facilitating innovation in connection with regulated activities'. Hence, the FSA clearly has a duty to take competition into account when pursuing its four primary objectives.

7.3 The FSMA (Section 155) further requires the FSA to conduct a CBA on new proposed rules. This is a useful technique for examining, in a rigorous and consistent way, the costs and benefits of new rules, including any positive or negative effects on competition. In practice, effects on competition do indeed form an important element of the FSA's CBA.<sup>37</sup> The FSA's approach to CBA also forms part of the wider two-year FSMA review.

#### OFT SCRUTINY

7.4 The FSMA also establishes a mechanism for scrutiny of the FSA by the OFT. Under Section 160(1) of the FSMA, the OFT has a duty to keep the regulating provisions and practices of the FSA under review for any significantly adverse effect on competition. If at any time the OFT considers that a regulating provision or practice has a significantly adverse effect on competition, it must make a report to that effect. The report must include details of the adverse

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<sup>37</sup> The current FSA approach to CBA is described in Alfon, I. and Andrews, P. (1999), 'Cost-Benefit Analysis in Financial Regulation—How to do it and how it adds value', FSA Occasional Paper Series 3, September.

effects on competition and be sent to HM Treasury, the Competition Commission and the FSA.

- 7.5 The Competition Commission must then investigate the matter and make its own report, unless it considers that, as a result of a change of circumstances, no useful purpose would be served by such a report. The Commission's report must state its conclusions on whether the regulating provisions or practices concerned have a significantly adverse effect on competition, and, if so, whether it considers that the effect is justified. If it concludes that the adverse effect is not justified, it must indicate what action the FSA should take. In such cases, HM Treasury has a duty to give a direction to the FSA on what action to take, taking into account what the Commission considered the FSA should do. HM Treasury can decline to follow the Commission's report, but must give its reasons for doing so.
- 7.6 The OFT has a team of people who prepare responses to FSA consultation documents. One example where the OFT has taken an active stance is in the debate on polarisation, as discussed in section 5 of this report.<sup>38</sup>
- 7.7 It is beyond the scope of this research to assess how this scrutiny mechanism has worked in practice. However, its importance is clear from the discussion in sections 5 and 6.

### **Treatment of RIEs and RCHs**

- 7.8 OFT scrutiny is also provided for in Part XVIII of the FSMA, which deals with RIEs and RCHs. These bodies perform certain regulatory functions in the markets/infrastructure they control. Chapter III in Part XVIII excludes the regulatory functions of the RIEs and RCHs from the application of Chapters I and II of the Competition Act 1998 (dealing with agreements and abuse of dominance, respectively). The Chapter I exclusion applies to the extent to which the agreement relates to the regulatory provisions of that body. The Chapter II exclusion applies to the 'regulatory practices' and actions related to the regulatory provisions of the recognised body.
- 7.9 The above provisions and practices by recognised bodies can instead be addressed under the scrutiny mechanism established in Chapter II of Part XVIII of the FSMA. This is similar to the scrutiny mechanism for FSA rules and

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<sup>38</sup> OFT (1999), 'The Rules on the Polarisation of Investment Advice', August. In 2002, the OFT published a response to the FSA consultation paper backing the FSA proposal for change of the regime. OFT (2002), 'Liberalisation, not polarisation—OFT's response to FSA Consultation Paper 121 "Reforming Polarisation: Making the Market Work for Consumers"', April.

practices, discussed above. It provides for a role for the OFT and subsequently the Competition Commission and HM Treasury.

- 7.10 One instance in which the OFT has applied this mechanism is the recent investigation into issuer charges by the LSE.<sup>39</sup> After the LSE agreed to reduce its fees, the OFT concluded that the adverse effect on competition was not significant, and hence it did not ask the Competition Commission to investigate the case.
- 7.11 It is beyond the scope of this Review to assess the effectiveness of this scrutiny mechanism.
- 7.12 A question that might be asked is whether the exclusion from the Competition Act 1998 is appropriate. However, the effects of this exclusion may at any rate be limited, for two reasons:
- the commercial (as opposed to regulatory) practices of the recognised bodies could still be investigated under the Competition Act 1998;<sup>40</sup>
  - under the 'modernisation' of EU competition law, in force since May 2004, national competition authorities and courts have greater powers to enforce Articles 81 and 82 of the EC Treaty directly.<sup>41</sup> Given that the activities of RIEs and RCHs have a cross-border dimension, the EU competition rules are likely to apply. This limits the effect of the FSMA exclusion of recognised bodies from the Competition Act 1998.

### **Dealing with monopoly problems**

- 7.13 Efficient market functioning can be distorted by monopoly or market power. The market analysis in section 3 identifies markets with competitive structures 'above' the threshold. Many competition issues in these markets could probably be dealt with under competition law where such law is applicable (for example, in the case of abuse of a dominant position). However, where market power is pervasive—for example, because the market is characterised by strong economies of scale or network effects and therefore tends towards natural monopoly—reliance on competition law alone may not always be sufficient.
- 7.14 Oxera's analysis has found one high-level market that may fit this description, namely clearing and settlement infrastructure. These systems have certain

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<sup>39</sup> OFT (2004), 'London Stock Exchange Issuer Fees', March.

<sup>40</sup> The distinction between commercial and regulatory practices of recognised bodies may not always be clear-cut.

<sup>41</sup> Chapters I and II of the Competition Act 1998 are modelled after Articles 81 and 82, respectively.

natural monopoly features and their infrastructure is essential to competitive activities further up and down the value chain (ie, trading platform services and custody services). Horizontal access is also important in relation to the cross-border integration of clearing and settlement systems across Europe.

- 7.15 The Recognition Requirements have some regard to access to clearing and settlement facilities, but the objective is to ensure that the business conducted by the facility is undertaken in an orderly manner, to afford proper protection of investors (Part I, Section 4 and Part III, Section 19 of the Recognition Requirements). There are no requirements to provide access (even where an access seeker meets membership requirements) and no guidance on pricing.
- 7.16 Sector-specific access regulation from a competition perspective (following the example of utility regulators) might be needed in these circumstances, as it is not clear whether application of the general competition rules, or of the competition scrutiny mechanism established in the FSMA, would be sufficient to deal with the natural monopoly problem.
- 7.17 The European Commission has dealt with access to CSD infrastructure under competition law. In June 2004, it found that Clearstream, the German CSD, had infringed competition law by refusing to supply cross-border securities clearing and settlement services and by applying discriminatory prices.<sup>42</sup> This seems to imply that the OFT—which, since May 1st 2004, has had powers to apply Articles 81 and 82 of the EC Treaty as well—could also address these issues under the competition rules directly.
- 7.18 Nevertheless, in addition to application of the competition rules, the European Commission has recently proposed a Framework Directive setting out sector-specific regulations dealing with access to clearing and settlement systems directly.<sup>43</sup>

## Regulatory versus market supervision

### SELF-REGULATION VERSUS GOVERNMENT REGULATION

- 7.19 One of the major changes of the FSMA with respect to the previous legislation was the move from self-regulation to government regulation in some areas. For example, the FSA took over the functions of the three remaining self-regulatory

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<sup>42</sup> European Commission (2004), 'Final Decision in Clearstream Case', press release, June 2nd.

<sup>43</sup> European Commission (2004), 'Clearing and Settlement in the European Union—The Way Forward', Communication to the Council and Parliament, COM(2004)312, April 28th.



organisations (SROs) that had been designated under the Financial Services Act 1986 (the Personal Investment Authority, the Investment Management Regulatory Organisation, and the Securities and Futures Authority).<sup>44</sup>

- 7.20 It is difficult to assess the effects on competition of this move from self-regulation to government regulation, and Oxera has not focused on this issue. In theory, in cases where the government is inherently better placed to carry out some regulatory functions (for example, where potential conflicts of interest may arise under self-regulation), the effect can be expected to be positive.
- 7.21 Two other areas where regulatory functions have moved to the FSA are worth exploring here, namely the listing authority (previously a function carried out by the LSE) and regulation of Lloyd's (previously not regulated). Both the LSE and Lloyd's have an important regulatory role in the respective markets they control—equity trading for the LSE and insurance for Lloyd's. At the same time, however, these institutions are commercial operators that face competitive pressure from other markets. Finding the right balance between self-regulation and FSA regulation is therefore complex.

#### UK LISTING AUTHORITY

- 7.22 As also discussed in section 5, Part VI of the FSMA moved some of the regulatory functions related to the official listing of securities from the LSE to the FSA, which is now the 'competent authority' and performs these functions as the newly established UK Listing Authority. The UKLA makes the listing rules and maintains the 'official list' of securities.<sup>45</sup>
- 7.23 From an economics perspective, this change sets a clearer boundary between government regulation and the functions carried out by the LSE. Companies seeking a listing of their securities need to comply with certain legal listing rules, as well as with the requirements set by the exchange on which they want to be traded (admission to trading requirements). Determining and enforcing the legal requirements is arguably more effective if done by a single body. In contrast, admission to trading rules can be set by each exchange.
- 7.24 Thus, the new structure under the FSMA probably has a pro-competitive effect as it means that the government (through the FSA/UKLA) is in charge of the 'monopoly' activity, instead of the LSE. Also, an admission to listing performs

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<sup>44</sup> Some forms of self-regulation remain in the industry—for example, the Banking Code, a voluntary code followed by banks and building societies, the compliance of which is monitored by the Banking Code Standards Board.

<sup>45</sup> Part VI, Section 95, also includes a competition scrutiny mechanism in relation to the competent listing authority (with a role for HM Treasury rather than the OFT).

an important signalling function for companies seeking to issue securities. The new structure means that companies no longer rely solely on the LSE for this signalling function, thereby further limiting the competitive advantage of the LSE over other exchanges.<sup>46</sup>

## LLOYD'S

- 7.25 Lloyd's is regulated by the FSA under Part XIX of the FSMA. It provides the FSA with a direct supervisory role in relation to the Lloyd's Society and its Council, and an indirect role in relation to members of the Society. In practice, this means that the FSA exercises a supervisory role, while the Lloyd's Council functions principally as a risk manager for its market.
- 7.26 Although the FSMA and the FSA Handbook have specified entry requirements for the managing agents in the Lloyd's market, these do not seem more stringent than the existing entry requirements set by the Lloyd's Council. As such, the FSMA regulation is unlikely to have a negative impact on the competitive structure of the Lloyd's market.
- 7.27 With respect to the functioning of the market, the risks in this insurance market are controlled by the bylaws issued by the Lloyd's Council. Rules aiming to ensure market confidence therefore already exist. As Oxera's analysis has highlighted, the Lloyd's syndicates compete not only with each other, but also with other UK and overseas insurance and reinsurance providers. Therefore, it is to be expected that Lloyd's has the right incentives to ensure that its market functions properly.

## Conclusion

- 7.28 The promotion or protection of competition is not among the primary regulatory objectives set out in the FSMA. However, the FSMA does establish important mechanisms to limit any adverse effects on competition that may arise from the FSA's rules and decisions.
- First, under Section 2(3), the FSA 'must have regard to' the need to minimise the adverse effects on competition that may arise from anything done in the discharge of its functions, and to the desirability of facilitating innovation and competition. Further, under Part X, Section 155(2), it is required to conduct a CBA on new proposed rules.

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<sup>46</sup> It should be noted that 'being admitted to trade on the LSE' still constitutes an important signalling function. However, the point made is that 'being admitted on the official list of the UKLA' also provides such a function, and, with respect to that function, other exchanges are no longer disadvantaged relative to the LSE.

- Second, the FSMA gives the OFT an important role in scrutinising the regulatory provisions and practices of the FSA (Part X, Chapter III) and of the recognised bodies (Part XVIII, Chapter II). It also provides a possible further role for HM Treasury, the Competition Commission and the FSA, should an adverse effect on competition be found.

- 7.29 In theory, these mechanisms should be sufficient to prevent or address most potential adverse effects of competition arising from regulation. To assess the effectiveness of these two mechanisms in practice is beyond the scope of the FSMA Competition Review. Here, Oxera emphasises their importance from a competition perspective only.
- 7.30 While the FSMA therefore contains mechanisms to prevent adverse regulatory effects on competition, it does not require the FSA to *actively promote* competition in areas where this might be beneficial from an economic welfare perspective. This is a direct result of not making competition a primary regulatory objective in the FSMA. While many competition concerns can be effectively addressed under competition law (the Competition Act 1998 and the EC competition rules), there are some areas where a regulator with a specific competition remit (like utility regulators) could arguably go further than the FSA is at present in trying to improve or promote the competitive dynamics of markets.
- 7.31 One such area is access to clearing and settlement infrastructure, which has certain natural monopoly characteristics (and is currently dealt with by the European Commission both under competition law and through proposed sector-specific regulation). Another area would be to seek to actively address entry barriers in the more concentrated markets (Types A and C).

## A APPENDIX: DESCRIPTION OF THE ANALYSIS OF THE 18 HIGH-LEVEL MARKETS

### Deposit-taking services for private consumers and SMEs—current accounts (Type A) and savings accounts (Type B)

#### COMPETITION INDICATORS

- A.1 The market for deposit-taking services for private consumers and SMEs consists of current accounts and savings accounts. The competition indicators for current accounts are assessed as being above the threshold. The HHI by number of current accounts is estimated at 1,543, as illustrated in Table A1.1, indicating that concentration in the market is medium/high.

TABLE A1.1 - MARKET SHARES (%) BY NUMBER OF CURRENT ACCOUNTS (2003)

Lloyds TSB	20.8
Barclays	19.7
RBSG	17.5
HSBC	14.8
HBoS	11.8
Abbey	5.5
Nationwide BS	4.1
Alliance & Leicester	2.9
Co-operative Bank	1.1
Yorkshire Bank	0.9
Other	0.6
HHI (2003)	1,543

Source: Datamonitor (2004), 'UK Current Accounts 2004'.

- A.2 The established market participants all have extensive branch networks that are likely to constitute an entry barrier in this part of the market. However, this has not precluded entry by the larger building societies that have the requisite national branch network. Furthermore, the Internet has enabled some new entrants (eg, Cahoot, smile, and First Direct) to enter without the need for a substantial branch network, although each of these is affiliated to a traditional service provider (respectively Abbey, The Cooperative Bank, and HSBC). Other entry barriers could include the importance of reputation as a supplier of banking services, and, possibly, the existing low rate of switching among consumers.

- A.3 A somewhat different picture emerges for savings accounts. There are more providers, including building societies and some new entrants. The Cruickshank Review (in 2000) estimated the HHI at 910, but this is likely to have decreased further. To provide savings accounts, it is not necessary to have an extensive branch network. Entry barriers are therefore lower than for current accounts. For example, some European banks (eg, ING) have been able to provide Internet savings accounts in the UK via 'passport' arrangements. These arrangements enable EU financial services companies to provide services in the UK while major supervisory obligations remain in the home country. The competition indicators for savings accounts are therefore assessed as being below the threshold.

#### RISK AND MARKET FAILURE INDICATORS

- A.4 The market failure/risk indicators for current accounts and savings accounts are assessed as being above the threshold. In the absence of regulation, depositors would be exposed to high levels of operational and default risks, particularly arising from credit risks.
- A.5 As is well known, system risk in combination with negative externalities means that a failure of a bank could have a disruptive effect on the whole banking system—for example, through the inter-bank market, or through a panic withdrawal or 'run' on the deposits of another bank. This is a problem due to the asset/liability mismatch of banks, which tend to borrow (from depositors) over short time periods, and lend over long time periods. Although its likely occurrence in the UK could be thought to be low, the impact of a systemic crisis would be significant.

#### REGULATORY FRAMEWORK

- A.6 Accepting deposits is specified as a regulated activity in the Regulated Activities Order 2001.<sup>47</sup> Capital requirements form an important part of banking regulation. These are based on the Banking Consolidation Directive<sup>48</sup> and Capital Adequacy Directive,<sup>49</sup> which in turn are based on the Basle Capital Accord of

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<sup>47</sup> FSMA 2000 (Regulated Activities) Order 2001, SI 2001/544.

<sup>48</sup> Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, *Official Journal L126*.

<sup>49</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC. *Official Journal L 145*, 30/04/2004 P. 0001 – 0044.

1988 set up by the Basle Committee on Banking Supervision.<sup>50</sup> This Committee made changes to the framework governing capital adequacy of internationally competitive banks (known as Basle II).<sup>51</sup> These attempt to align capital requirements more closely with underlying risk, such as the credit and operational risk faced by a bank.

- A.7 Another important element of banking regulation is the voluntary Banking Code which sets standards of practice for deposit-taking institutions when dealing with personal consumers in the UK. The Code is a form of self-regulation, monitored by the Banking Code Standards Board, and reviewed every two years.

### **Deposit-taking services for large business customers (Type D)**

- A.8 Deposit-taking services for large business customers are assessed as a separate market to deposit-taking services for private consumers and SMEs. Large businesses will process a much larger volume of money transmission transactions (eg, payment of salaries), and are likely to be able to achieve better terms and conditions. Furthermore, large customers often have a range of alternatives to meet their money transmission (and lending) needs—for example, they can use market operations and have access to debt markets.

#### COMPETITION INDICATORS

- A.9 The competition indicators are assessed as below the threshold. This market is less concentrated than the market for deposit-taking services for private customers and SMEs. Market participants include large clearing banks, investment banks, and overseas banks with an office in the UK serving, in particular, overseas companies based in the UK. Large firms may also be able to access the money markets directly. As a corollary of this and the informed nature of the buyers, there is countervailing buyer power in this market.
- A.10 Furthermore, although an extensive branch network is likely to constitute a significant barrier to new entrants in the market for current accounts to private customers and SMEs, this is unlikely to apply in the large business banking market. For example, market participants may require only an office, most often in London, as well as the ability to support the banking and commercial services that clients may require.

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<sup>50</sup> Basel Committee on Banking Supervision (1988), 'International convergence of capital measurement and capital standards', July.

<sup>51</sup> Basel Committee on Banking Supervision (2004), 'International Convergence of Capital Measurement and Capital Standards: A Revised Framework', June.

- A.11 Switching costs are likely to be low in this market: large business customers have the resources to ensure that they receive the best available deal, as well as greater incentives than SMEs or private customers to do so.

#### RISK AND MARKET FAILURE INDICATORS

- A.12 The market failure/risk indicators are assessed as being below the threshold. Although the nature of risk is the same as in the market for deposit-taking services for private customers and SMEs, large customers are likely to be in a better position to choose an appropriate bank or to be able to bargain for safeguards to reduce potential losses. There will therefore be less information asymmetry in the large business market than in that for deposit-taking services for individuals and SMEs.

#### **Investment and pension advice to retail customers (Type B)**

- A.13 There are two main routes by which potential retail customers can be offered advice. The first is via the direct sales force of the provider of the investment product. The advice provided by the direct sales force is limited to choosing between the different products of a single provider. The second is via IFAs, who advise across the whole range of available investment products without the restrictions of a direct sales force. The distinction between these two types of advice provider is largely regulatory. In addition, investment products can be sold directly to retail customers without advice being provided.

#### COMPETITION INDICATORS

- A.14 The market for investment advice to retail customers could be considered as atomised. There are more than 11,000 IFA firms in this market, resulting in very low concentration (HHI below 150).<sup>52</sup> This reflects relatively low economies of scale and barriers to entry, which mainly result from the need for professional qualifications. Moreover, IFAs compete with other distribution channels for these products—for example, around 20% of CIS are sold directly to the consumer without advice, and so the market may be even more unconcentrated than the purely IFA market share figures would suggest.
- A.15 As a consumer market, there is a lack of buyer power in this market. The small size of IFA firms also means that their geographical scope is in general narrow, as most firms are not national, but rather regional or local.

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<sup>52</sup> Sandler, J. (2002), 'Medium and Long Term Savings in the UK: A Review', report prepared for HM Treasury, July 9th, available at [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk).

A.16 Overall, the market for investment advice to retail customers is assessed as being below the threshold; problems with competition in the IFA sector do not arise from the market structure.

#### RISK AND MARKET FAILURE INDICATORS

A.17 The risk and market failure indicators for the market for investment advice to retail customers are above the threshold. Two factors are of particular importance in reaching this conclusion:

- the high operational risk in the market, resulting from the possibility of inappropriate investment advice being given. If inappropriate advice were given, there would seem to be some risk of substantial losses being incurred by investors who did not take the possibility of such events into account;
- the asymmetric information in the market—main sources are the inability of the customer to observe the quality of the advice being provided until it has been acted upon (and even after action it may not be possible to assess quality); the possibility of the IFA not knowing the full financial circumstances of the customer; and consumers themselves not knowing about the full range of financial products.

#### REGULATORY FRAMEWORK

A.18 The Conduct of Business rules regulate the manner in which IFAs can deal with their clients. Among the most important of these rules are the following.

- *Know your customer*—the IFA must ensure that they have sufficient information on a customer before recommending any products.
- *Suitability*—firms must only recommend products that are suitable for the customer, and must provide a letter detailing suitability.
- *Customer understanding*—customers must understand the risks involved in the product.
- *Charging*—charges must not be excessive, and must be disclosed before business is conducted.

A.19 Furthermore, the polarisation regulations have had an important impact on how the market has developed (as discussed in section 5 of this report). In general, IFAs are not allowed to have significant financial links with product providers. In the event that such links exist, the better-than-best rule comes into play, whereby the IFA can only recommend a product of a linked provider if no other product would fulfil the needs of the customer at least as well. In practice, this



has tended to prevent the sale by IFAs of products supplied by linked providers. On the other hand, direct sales forces are only permitted to sell the products of a single provider.

- A.20 The polarisation regime is, however, due to change in the near future, at which point multi-tied agents, with links to more than one provider, will be permitted. This is likely to be a significant change to the regulation of this sector.
- A.21 Overall, the market for investment advice to retail customers is one of the most heavily regulated areas of the financial services sector. This reflects the significant risk in relatively uninformed agents making investments, and the important role of IFAs and direct sales forces in guiding such buyers towards financial products.

### **Investment advice to institutional clients—equity research (Type D)**

- A.22 Equity research involves the analysis of the underlying properties of an equity. Some forms of advice are in terms of recommendations as to whether to buy, sell, or hold an equity. Other forms focus more on broader market developments. Analysts may also make predictions in terms of 'target prices', and for underlying characteristics of a firm such as dividends payable and profits. Most large investment banks and stockbrokers will have a research function within their organisation that also offers advice to external customers. In addition, there are 'independent research providers'.

### **COMPETITION INDICATORS**

- A.23 Market concentration is low, potentially as a result of low barriers to entry and low economies of scale. Apart from the researchers in investment banks, estimates provided to Oxera indicate that there are between a few dozen and several hundred independent firms within this sector. Furthermore, there has been considerable entry from overseas. One potential entry barrier for independent firms is that the large investment banks often bundle research together with brokerage services. A way around this is for the independent providers to sell their services through soft commission arrangements.<sup>53</sup>
- A.24 The various types of equity analysts (for example, technical and fundamental analysts) may not necessarily compete directly with one another. However, the analysis would not be expected to change if technical and fundamental analysts were to be treated as being in different markets. Overall, the competition indicators are below the threshold.

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<sup>53</sup> See Oxera (2003), 'An Assessment of Soft Commission Arrangements and Bundled Brokerage Services in the UK', report for the FSA, April.

## RISK AND MARKET FAILURE INDICATORS

- A.25 The principal market failure problems in equity analysis are those of asymmetric information and public goods. Analysis is a public good as it is non-rival and, once disseminated, it is difficult to prevent people acting upon the information who have not paid for it (the free-rider problem). From a public policy perspective, equal access to information can enhance the functioning of financial markets. However, it does create problems regarding the manner in which research can and should be funded.
- A.26 Asymmetric information occurs in a range of ways. First, the methodology adopted by analysts can be opaque to clients, and any private discussions between a firm and analysts clearly represent an informational asymmetry. Furthermore, academic research has previously found systematic biases in equity analysis, as well as a 'herd effect', whereby analysts emulate each other's opinions.<sup>54</sup>
- A.27 Despite these issues, risk and market failures in the segment for equity research are not sufficiently great to place it above the threshold, particularly given that this a market with relatively sophisticated consumers (ie, institutional fund managers and investors who undertake research themselves).

### **Investment advice to institutional clients—credit-rating agencies (Type C)**

- A.28 Credit-rating agencies rate the creditworthiness of the debt of companies (and countries). Their ratings provide a mechanism for purchasers of corporate bonds to judge the risk they are taking on by investing in a firm. As they provide advice to institutional investors, they act as the analogue of equity research, albeit for a different class of securities. They were therefore included as part of the high-level market for investment advice to institutional clients.

## COMPETITION INDICATORS

- A.29 There is high concentration in the segment for analysis by credit-rating agencies, with three main players globally. This is driven by substantial barriers to entry, arising from US-based regulations<sup>55</sup> and by the need for a reputation and track record of accurately providing ratings. There are also economies of scale since the complexity of the financial transactions undertaken by the

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<sup>54</sup> Chan, L., Karceski, J. and Lakonishkok, J. (2003), 'Analysts' Conflicts of Interest and Biases in Earnings Forecasts', NBER Working Paper 9544, cited in FSA (2003), 'Conflicts of Interest: Investment Research and Issues of Securities', October.

<sup>55</sup> Global standards are to some extent set by the US designation of 'Nationally Recognised Statistical Ratings Organisation' (NRSRO).

largest firms necessitates a relatively large number of staff. Countervailing buyer power is absent in this market, as issuers, rather than the consumers of the credit-rating reports, pay the credit-rating agencies. Overall, the competition indicators are assessed as being above the threshold.

#### RISK AND MARKET FAILURE INDICATORS

- A.30 There are significant public goods issues in this market. As is the case for equity research, the primary output of credit-rating agencies is information, a non-rival good that it is difficult to exclude individuals from obtaining or using. This is possibly reflected in the fact that credit-rating agencies do not receive payments from the consumers of their reports, but rather from the firms that have issued debt and want it to be rated. This has the impact of creating a potential conflict of interest for credit-rating agencies.
- A.31 There is also some degree of asymmetric information with respect to the methodology adopted for rating debt, and the express provision for credit-rating agencies to be provided with information that is not available to the market as a whole. As such, it is difficult to judge the performance of credit-rating agencies until after the event, particularly as the event being predicted—default on bonds—is intrinsically rare.
- A.32 However, all the other market failure and risk indicators are either low or medium. Overall, credit-rating agencies therefore fall below the threshold.

#### REGULATORY FRAMEWORK

- A.33 Credit-rating agencies are not currently regulated under the FSMA, as they do not provide 'advice', in the sense used by the FSA. Credit-rating agencies rate the creditworthiness of firms, rather than telling investors whether they should purchase the debt of the firm under review. FSA Consultation Paper 205, regarding conflicts of interest in investment research, does not apply to credit-rating agencies.<sup>56</sup>

#### **Investment advice to institutional clients—pension fund consultants (Type C)**

- A.34 Investment consultants advise defined benefit pension funds on the allocation of their assets between various types of assets and between fund managers. Since investment consultants provide a type of advice, they were included as part of the high-level market for investment advice to institutional clients.

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<sup>56</sup> FSA (2003c), 'Conflicts of Interest: Investment Research and Issues of Securities—Feedback on CP171, Made Text and Limited Further Consultation', CP 205, February.

## COMPETITION INDICATORS

- A.35 The market for investment advice to institutional clients is concentrated. The Myners report provides details of market share which imply that the HHI in this market is around 1,800, with the four largest players (William Mercer, Watson Wyatt, Bacon & Woodrow, and Hymans Robertson) accounting for about 85%.<sup>57</sup> This concentration may result from the presence of some entry barriers in the industry, which may be brand-related, as well as significant economies of scale in the research operations of the firms.
- A.36 Furthermore, the Myners report points out that many funds retain the same investment consultant for decades at a time. This implies that switching costs—even if only due to relationships between the consultants and the firms they are advising—may be significant. Potentially countering this is that the firms being advised are generally large organisations with significant bargaining power.
- A.37 Overall, the provision of investment advice to institutional clients falls above the threshold for competition indicators.

## RISK AND MARKET FAILURE INDICATORS

- A.38 The market failure/risk indicators are also assessed as being below the threshold. There is some degree of asymmetric information in the market, particularly when consultants are advising pension fund trustees who are not, themselves, professional investors. This may be reflected in the substantial similarities that the Myners Report found in the advice to different pension funds—in this case, it may be that some pension funds are accepting advice that is not fully appropriate for their needs.

## REGULATORY FRAMEWORK

- A.39 Investment consultants are not regulated under the FSMA as they do not provide 'advice' in the sense used by the FSA. The actuarial arms of investment consultants are regulated under the Pensions Act 1995. Following Lord Penrose's Inquiry into the Equitable Life case, HM Treasury asked Sir Derek Morris in April 2004 to conduct an independent review of the actuarial profession. This review also covers the activities of the pension fund consultants.

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<sup>57</sup> Myners, P. (2001), 'Institutional Investment in the United Kingdom: A Review', March, commissioned by HM Treasury.

## **Investment banking services—IPOs (Type C) and other (Type D)**

A.40 The core activities of an investment bank department within a financial institution are in the area of 'capital markets' (in particular, IPOs and subsequent offerings) and 'corporate finance' (mergers and acquisitions, or M&As). The essence of these activities is that sellers and buyers are brought together. Investment banks play mainly an advisory role, although they may sometimes also take risks themselves (eg, in the case of underwriting IPOs and subsequent offerings). Supporting activities often carried out by investment banks include research and relationship management.

### **COMPETITION INDICATORS**

A.41 The competition indicators for the activities undertaken by investment bank departments give a mixed picture. Reputation and experience appear to be important factors for companies in selecting an investment bank for IPOs and, to a lesser extent, subsequent offerings. Furthermore, companies often use the investment bank division with which they already have a relationship. 'Distribution capability' is also a key factor in the selection process. This is because most IPOs are organised by means of a book-building among the investment bank's own clients. A firm's distribution capability is closely linked to the scale of its brokerage services to institutional clients.

A.42 The competition indicators for the market for the management of IPOs are assessed as above the threshold. The market share data shown in Table A1.2 indicates that the average HHI in this market was around 1,600 during the period 2001–03. Reputation and experience appear to be important factors for companies when selecting an investment bank for IPOs. Furthermore, companies often seem to use the investment banking division for the management of their IPO with which they already have a relationship, indicating some reluctance to switch to another investment bank. In other words, it is likely to be relatively difficult for new entrants to penetrate this market.

TABLE A1.2 - MARKET SHARE OF BOOKRUNNERS IN IPOS, AVERAGE BETWEEN 2001 and 2003

	<i>Rank value (US\$m)</i>	<i>Market share (%)</i>	<i>Number of issues</i>	<i>Market share (%)</i>
Merrill Lynch	4,769.9	34.1	6	7.1
Citigroup	1,708.6	12.2	5	5.9
Goldman Sachs	1,331.7	9.5	2	2.4
CSFB	1,100.0	7.9	2	2.4
Collins Stewart	988.8	7.1	15	17.6
Deutsche Bank	861.6	6.2	2	2.4
UBS	717.3	5.1	4	4.7
HSBC	457.9	3.3	2	2.4
JP Morgan	438.5	3.1	1	1.2
Cazenove	432.2	3.1	3	3.5
<b>Top ten total</b>	<b>12,805.3</b>	<b>91.5</b>	<b>61</b>	<b>72.9</b>
<b>Industry total</b>	<b>13,999.8</b>	<b>100</b>	<b>85</b>	<b>100</b>

Note: Data for number of issues is not based on rankings by number of issues but rather the relevant data for the particular companies in the top 10 on the basis of value.

Source: Bloomberg.

A.43 The competition indicators for other investment bank division activities are assessed as being below the threshold. The markets for the management of subsequent offerings and for advice on M&As are less concentrated than the market for management of IPOs with many US and European investment banks having successfully entered the UK market.

#### RISK AND MARKET FAILURE INDICATORS

A.44 A distinction can be made between the advisory stage of IPOs, subsequent offerings and M&As, and the transaction execution stage. At the advisory stage, clients are exposed to the risk of bad advice, possibly due to misinterpretation of information by investment banks. At the execution stage, investment banks rely on the brokerage division, and other service providers, such as clearing and settlement and custody providers. These services are described elsewhere in this report.

A.45 Although default and systemic risk are likely to be low, there could be some negative externalities in the case of IPOs: If an investment bank fails to place an IPO in the market, this could affect market sentiment and therefore the success of other IPOs. M&As are based on individual circumstances and market situations. Negative externalities are therefore less likely to appear in the market for M&A advice.

- A.46 As assessment of the existence of asymmetric information in the market for management of IPOs gives a mixed picture. Although companies are sophisticated customers, they may find it difficult to assess the quality of investment banks ex ante. This is to some extent offset by the fact that reputation and experience are likely to give an indication of the quality of services. Furthermore, although, in general, it may be relatively straightforward to determine whether an IPO or subsequent offering was a failure or success, it may be difficult to assess whether failure or success can be attributed to the investment bank or other factors, such as (bad) luck and negative or positive market sentiment. This is to some extent offset by the fact that large companies are sophisticated buyers and are likely to have a good understanding of the value of their company.
- A.47 Overall, the risk and market failure indicators are assessed as below the threshold.

#### REGULATORY FRAMEWORK

- A.48 Investment banking services discussed in this section are regulated by FSMA. Advising on investments, arranging deals in investments and managing investments are the regulated activities most likely to be relevant in the context of the management of IPOs and subsequent offerings, and provision of M&A advice (Section 22 and Articles 25, 37 and 53 of the Regulated Activities Order 2001). Consequently, authorised investment banks are subject to the rule-making, investigatory and disciplinary powers of the FSA, as granted in the FSMA. They are also subject to the Principles for Business Sourcebook and the Conduct of Business Sourcebook.
- A.49 There are specific rules on the stabilisation of the price of securities after issue.<sup>58</sup> The rules indicate that stabilisation is allowed for a limited time only, 'the stabilisation period'. For shares, this starts when the issue is priced and ends at the earlier of 30 days after the closing data; or 60 days after the allotment of securities to investors. For bonds, it may start a little earlier. Stabilisation is only allowed for securities admitted to trading on regulated markets, such as the LSE.
- A.50 The investment banking sector has been subject to scrutiny in recent years, in particular in relation to conflict of interests and excessive pricing. In 1999/2000 the FSA reviewed transactions of UK IPOs and concluded that it had not found any evidence of excessive commissions or aftermarket obligations (laddering),

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<sup>58</sup> Section 144 of the FSMA grants the FSA the specific power to make rules on stabilisation (see Market Conduct, MAR2, Price Stabilisation Rules).

as alleged to have occurred in the US IPO market.<sup>59</sup> In May 2004, the FSA issued specific rules on abusive practices such as laddering and spinning.<sup>60</sup>

### **Retail investment funds (Type B)**

- A.51 There are several types of retail investment fund: unit trusts are funds established by managers in the form of trusts to manage a portfolio of securities; and open-ended investment companies (OEICs) are corporate funds set up as special purpose vehicles with the single objective of investing investors' funds in securities. These two types of funds are known as CIS.
- A.52 Investment trusts are a third type of collective investment available to retail investors; however, as they have a different internal structure, they are not classified as CIS. These are closed-ended investment companies that issue shares to investors and invest the proceeds in a portfolio of securities of other companies. Although different in structure, they are often managed by fund management groups that also manage CIS, and are likely to fall within the same high-level market. Exchange-traded funds are similar to index-tracking CIS, although they are continuously priced to market. Unit-linked life funds, despite being an insurance product, contain a strong investment element and are often marketed as investments. Other types of retail investment fund, such as structured deposits and capital-at-risk products, may also be included within the same high-level market.

### **COMPETITION INDICATORS**

- A.53 The concentration of the retail investment funds market is low. As shown in Table A1.3, the market share of the top ten providers of CIS is 45.2%, and the HHI for the market is 308. The largest player in this market has a market share of less than 10%. If investment trusts and exchange-traded funds were added into this market, the level of concentration would be likely to fall further. The

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<sup>59</sup> Reported in FSA (2002), 'Market Watch', 5, October.

<sup>60</sup> Laddering refers to the practice whereby IPO shares are offered to particular clients by underwriting firms under the understanding that they will purchase more shares at a specified price after the opening company begins publicly trading. Laddering may artificially inflate the value of the stock. The term 'spinning' refers to the practice of allocating shares to individuals who are officers of firms from which the bookrunner is seeking investment banking business. The FSA has pointed out that these practices are contrary to the Principles for Businesses. The FSA surveyed authorised firms on these issues and found considerable variance in firms' systems and procedures in this area, and has therefore issued an amendment to the Conduct of Business Sourcebook which came into force on May 1st 2004. This sets out guidance on systems, controls, and procedures that the FSA expects firms to have in place.



largest investment trust, Foreign & Colonial Investment Trust, has a market share of around 7%.<sup>61</sup>

TABLE A1.3 - MARKET SHARE OF TOP 10 FUND MANAGEMENT COMPANIES (UNIT TRUSTS, ICVCS)

<i>Company</i>	<i>Funds under management (£ billion)</i>	<i>Market share (%)</i>
Fidelity Investments	21.2	9.1
Threadneedle Investments	12.0	5.1
Scottish Widows Unit Trust Managers	11.7	5.0
Invesco Perpetual	11.3	4.8
Legal & General Unit Trust Managers	10.5	4.5
M&G Group	9.1	3.9
Schroder Investments Ltd	8.9	3.8
Halifax Investment Fund Managers	8.0	3.4
Gartmore Investment Management	6.8	2.9
SLTM	6.3	2.7
<b>Top ten total</b>	<b>105.8</b>	<b>45.2</b>
<b>Whole market total</b>	<b>233.4</b>	<b>100</b>

Sources: IMA, November 2003; and Oxera calculations.

A.54 Entry barriers appear to be relatively low in this market, and relate mainly to specific expertise in fund management. Reputation may also represent a barrier to entry. Economies of scale, although difficult to estimate precisely, also appear to be low, given the small size of funds relative to the overall size of the market. On the other hand, costs of switching between CIS firms and life insurers can be significant because of up-front charges of up to 5% although such charges are normally waived when switching within a firm's range of funds, and, for example, can be reduced by using fund supermarkets. Some unit trusts operate dual pricing, whereby investors usually pay or receive a price reflecting the costs of dealing in the underlying shares (including stamp duty in relation to UK securities). Investment trusts do not make up-front charges. In common with many retail markets, there is little buyer power in this market.

A.55 Vertical integration is relatively low in this market. There is little integration with IFAs, possibly due to the polarisation regime detailed above. In addition, in comparison with many European countries, bancassurers have a relatively low market share, with a substantial number of independent fund management

<sup>61</sup> See Mintel (2003), 'Collective Investments', August.

groups. Furthermore, in some mutual funds there is a separation of fund provision and asset management activities.

- A.56 Overall, the competition indicators place this market below the threshold.

#### RISK AND MARKET FAILURE INDICATORS

- A.57 Operational risks are a significant concern in this market. Such risks may arise from breaches of fund guidelines, misdealing, and valuation errors, among other causes. There are numerous small-loss events in these categories. Asymmetric information is another potential problem, as small investors may have difficulty in choosing between the many similar funds available to them. Furthermore, investors are often unable to assess adequately the risks being taken by a fund manager, or the relative performance of a fund in which they have invested. Monitoring across the hundreds of mutual funds available is likely to be particularly costly for investors; this is one of the drivers behind the existence of a substantial IFA sector.

- A.58 Financial and default risk is highly variable across the elements of the investment products for the retail sector. Unit-linked life funds are not strictly segregated from the assets of the life insurance company, and so the default risk on these products is high (which is addressed by FSA rules on solvency). On the other hand, unit trust assets are held in trust, and the default risk on these products is low. As these products are subject to trust law, they are legally protected, regardless of how the financial services industry is regulated. This protection is also offered under depositary arrangements for ICVCs.

- A.59 These risks and market failures imply that investment products for retail investors are assessed as being above the threshold.

#### REGULATORY FRAMEWORK

- A.60 Establishing and operating CIS, as well as managing investments, are activities regulated under the FSMA, as set out in the Regulated Activities Order 2001. Part of the FSMA rules on CIS are based on the UCITS Directive.<sup>62</sup> CIS are the only financial products in the UK that are subject to specific product regulation under FSMA. Sections 235–7 of the Act define a CIS, and Sections 247–8 give the FSA direct powers to make rules for unit trusts. Section 262 also provides for HM Treasury to make regulations for ICVCs. These regulations are implemented in secondary legislation (the Open-ended Investment Companies Regulations 2001), which establishes the corporate code for ICVCs and gives the FSA powers to make rules for ICVCs.

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<sup>62</sup> Directive 85/611/EEC as amended.

- A.61 The CIS Sourcebook of the FSA Handbook contains the FSA rules on unit trusts and ICVCs. These specify a range of regulations: conflicts of interest in the operation of the fund must be resolved in the interests of investors; there must be an independent trustee to safekeep fund assets; and investors must be able to redeem units at a price based on the net asset value. The ability of the fund to borrow is limited, and there must be appropriate disclosure about the fund before the point of sale. A new sourcebook for CIS was introduced in April 2004, setting out rules for authorised funds that will become operational by February 2007.
- A.62 The rules do not apply to all retail investment funds. For example, investment trusts are subject to company law and to FSA listing rules. This implies some differential regulation between products in the same high-level market for retail investment funds.<sup>63</sup>

### **Fund management services for institutional clients (Type D)**

- A.63 The primary task of fund managers is to invest client funds in a portfolio of financial assets that will best meet their clients' needs. The majority of assets are managed on behalf of institutional clients (90%), with insurance companies and pension fund assets being the largest clients in terms of assets under management.

#### COMPETITION INDICATORS

- A.64 The competition indicators are assessed as being below the threshold. Entry barriers may include factors such as expertise, past performance and reputation. These are unlikely to be significant, but may explain why entry into the UK market has mainly been observed for firms already well established in the USA and elsewhere, such as Capital International, Fidelity and JP Morgan.<sup>64</sup> However, concentration is low (the HHI is estimated at around 230<sup>65</sup>) and switching costs are also likely to be low. Although fund managers are typically

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<sup>63</sup> The FSA has announced the intention to conduct a review of the rules for listed investment companies. Part of this review will include a consideration of the difference between this regime and the CIS regime. See FSA (2004), 'The Listing Review and Implementation of the Prospectus Directive', Consultation Paper 04/16.

<sup>64</sup> Myners, P. (2001), 'Institutional Investment in the United Kingdom: A Review', March, commissioned by HM Treasury.

<sup>65</sup> Based on data from the Investment Management Association for the year 2001.

selected for a long period, the contracts can usually be easily terminated by pension funds.<sup>66</sup>

- A.65 Furthermore, fund managers in the UK are exposed to international competition. More than 30% of the total funds under management in the UK are managed on behalf of overseas clients. Competition between UK and non-UK fund managers is not only for the business of overseas investors. Although UK pension funds often tend to use UK-based fund managers, some use overseas fund managers, in particular for mandates whose underlying assets are also traded abroad.<sup>67</sup>

#### RISK AND MARKET FAILURE INDICATORS

- A.66 The market failure/risk indicators are assessed as being below the threshold. Pension funds and other institutional investors using fund managers are exposed to financial/default risks and operational risks such as misdealings (eg, execution errors), valuation errors and fraudulent behaviour. However, they may be in a position to negotiate contractual agreements with the fund manager or external custodian that mitigate their risk exposures even in the absence of regulatory protection.
- A.67 Furthermore, market failures due to asymmetric information are less pervasive in the institutional fund management market than in the retail sector. Unlike retail investors with limited information and expertise, institutional clients are likely to be actively involved in the dynamic management of their portfolio and thus professionally informed about opportunities available in the market. Pension fund trustees (or their appointed pension fund consultant) select fund managers according to past performance, service quality and price (management fee). While evaluation of a fund manager's performance is difficult, pension funds can, and regularly do, switch to another fund manager if dissatisfied with past performance.<sup>68</sup>

#### **Hedge funds (Type B)**

- A.68 There is no widely agreed definition of hedge funds, but the FSA suggests that these funds usually have the following characteristics:<sup>69</sup> they organise themselves as private investment partnerships or offshore corporations, pay

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<sup>66</sup> The finding that switching is fairly straightforward and frequently observed among pension funds is documented in the Myners report (2001) and Oxera (2003), 'An Assessment of Soft Commission Arrangements and Bundled Brokerage Services in the UK', report prepared for the FSA.

<sup>67</sup> Oxera (2003), *ibid.*

<sup>68</sup> Oxera (2003), *ibid.*

<sup>69</sup> FSA (2002), 'Hedge Funds and the FSA', Discussion Paper 16, p. 1.

performance fees to management, have a high net-worth investor base, and employ a variety of trading strategies across a range of instruments.

#### COMPETITION INDICATORS

- A.69 While difficult to assess precisely, the concentration of the hedge fund industry seems to be low. The market is global, with most hedge funds domiciled offshore. In Q1 2004, the largest fund in the world (Caxton Associates) had a market share of only around 1.4%; and, according to a recent report, there were 513 funds operating out of London.<sup>70</sup> It has been estimated that 45% of funds have less than \$25m under management,<sup>71</sup> which also seems to point towards low economies of scale, while the major barrier to entry is ensuring that the manager has sufficient skill to operate in the industry.
- A.70 For most funds, there are likely to be some switching costs, depending on the precise charging structure. Overall, however, the competition indicators raise few issues, and the market comes some way below the threshold in this regard.

#### RISK AND MARKET FAILURE INDICATORS

- A.71 Oxera's analysis points towards operational, financial and default and systemic risks being major issues in the operation of hedge funds. These risks place hedge funds above the threshold for risks and market failures.
- A.72 Operational risk occurs in several areas, including fraud risks, trading outside guidelines, misrepresentation and resource inefficiencies. Financial risk—in particular, counterparty risk—is derived from the level of gearing undertaken (to varying degrees) by hedge funds. Furthermore, short selling, derivatives and highly leveraged investments imply that hedge funds, by their nature, expose the wider market to systemic risk. Many of these risks were demonstrated in the failure of the Long-Term Capital Management fund in the USA.

#### REGULATORY FRAMEWORK

- A.73 Hedge funds are predominantly classified as unregulated CIS—the FSMA has no direct authority over them because they are located offshore. However, the marketing of hedge funds within the UK is regulated. Under Chapter 3 of the Conduct of Business Sourcebook and the FSMA 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001, the marketing of hedge funds is restricted to intermediate customers, market counterparties, or suitable

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<sup>70</sup> International Financial Services London (2004), 'Hedge Funds', City Business Series, p. 2.

<sup>71</sup> International Financial Services London (2004), op. cit., p. 3.

private customers (who are often required to make substantial minimum investments).

- A.74 Hedge fund managers operating within the UK must be authorised. However, since hedge funds are not sold to retail customers, and in many cases the only customer of a hedge fund manager is the offshore-domiciled hedge fund, the usual risk rating adopted by the FSA is low. Other regulatory concerns of the hedge fund industry relate to short selling, and to money laundering—a particular concern due to the structure of the market for hedge funds. The FSA has recently considered the market restrictions on short selling to be broadly sufficient.<sup>72</sup>

### **Brokerage and fund management services for private customers (Type B)**

#### COMPETITION INDICATORS

- A.75 This market covers brokerage and private wealth management offered to individuals seeking to create their own portfolio of shareholdings. Services vary from execution-only services, similar to the service provided to institutional investors (although on a smaller scale), to advisory or comprehensive discretionary services, similar to investment management services offered to institutional investors.
- A.76 The competition indicators are assessed as being below the threshold. The market for providing brokerage and fund management services for private customers is unconcentrated. Traditional service providers include banks, building societies and insurance companies, as well as retail brokers. The Association of Private Client Investment Managers (APCIMS) has more than 220 members, suggesting low concentration—this low concentration is seen in all three forms of retail brokerage: execution-only services, advisory services, and discretionary services.<sup>73</sup> Entrants to the market require expertise, start-up capital and membership of trading platforms. The operation by the London Stock Exchange of Proquote and the RSP Gateway has provided centralised hubs for connecting private client brokers and retail service providers (RSPs), making it easier for new companies to enter this market. Transferring a brokerage account seems to be relatively simple, but may be costly owing to the transfer fee charged by some brokers for moving equities out of an account (and sometimes for moving them into an account). Competition from foreign stockbrokers is likely to be limited given that most private clients will use a domestically located stockbroker.

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<sup>72</sup> FSA (2002), 'Short Selling', Discussion Paper 17, October.

<sup>73</sup> Data provided by APCIMS.

## RISK AND MARKET FAILURE INDICATORS

- A.77 The market failure/risk indicators are assessed as being above the threshold. Operational and financial/default risks are significant in the absence of regulation. Clients who have passed funds to a brokerage firm for execution of trade or for management would be exposed to the risk of that firm defaulting. Furthermore, there is likely to be asymmetric information between clients and brokers about the investment markets. Retail investors may not be in a good position to assess the quality of brokerage execution and investment advice.

## REGULATORY FRAMEWORK

- 7.32 The activities of retail client stockbrokers come under the FSMA.<sup>74</sup> The principal FSA rules for retail brokerage are contained in the Conduct of Business Sourcebook and the Client Assets Sourcebook of the FSA Handbook. Furthermore, retail brokers are subject to capital requirements based on the Capital Adequacy Directive. This Directive imposes capital requirements of 12% of annual income (averaged over three years) on retail brokerages. Another relevant element of European regulation is the Investment Services Directive,<sup>75</sup> which has recently been replaced by the Market and Financial Instruments Directive<sup>76</sup> on markets in financial instruments. This includes provision for the protection of retail investors, in terms of their assets, advice or information.

### **Brokerage services for institutional clients (Type D)**

- A.78 Brokers typically receive instructions from fund managers who manage the asset portfolios of institutional investors. The fund managers make the investment decisions and the brokers execute the buy or sell orders on a variety of trading platforms, such as the London Stock Exchange order book (SETS), broker-to-broker trades, in-house matching of trades by the broker itself, or alternatives such as Instinet and virt-x.
- A.79 The specific broker used by a fund manager to execute an order may vary according to type of security—eg, equity, fixed-income securities or derivatives. Trades in fixed-income securities and derivatives are most frequently undertaken on a principal basis (ie, the broker transacts directly with the counterparties to a deal, and takes a position). The broker used may also vary according to geography—fund managers may use brokers located abroad, in particular when

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<sup>74</sup> These activities include dealing in investments as principal or agent, advising on investments, arranging deals in investments as principal or agent, advising on investments, and arranging deals in investments and managing investments.

<sup>75</sup> Directive 93/22/EC.

<sup>76</sup> Directive 2004/39/EC.

the underlying assets are traded abroad. Similarly, a broker in the UK may execute business on behalf of a fund manager managing assets held outside the UK. While trade execution is the main service offered by brokers, they also offer services such as access to analysts and research.

#### COMPETITION INDICATORS

A.80 The competition indicators are assessed as being below the threshold. The HHI is estimated at around 440 for equity brokers, 340 for derivatives brokers, and 350 for bond brokers, indicating that concentration is low.<sup>77</sup> The market for 'difficult' equity trades (ie, large or low-liquidity transactions) is more concentrated than for regular trades, but unlikely to be highly concentrated as there are still several larger brokers able to execute difficult trade transactions. Entry may be significant in the market for difficult trades. To be able to execute difficult trades, a broker must have good access to trading opportunities, a network of counterparty buyers and sellers, as well as in-house expertise and know-how. Furthermore, brokers providing execution services of difficult trades often offer a bundle of services, including research and access to analysts, making it more difficult for execution-only brokers to enter the market.<sup>78</sup> To compete with full-service brokers, execution-only brokers often provide research as well (either in-house or, more often, through soft commission arrangements).

#### RISK AND MARKET FAILURE INDICATORS

A.81 The market failure/risk indicators are assessed overall as being below the threshold. Yet, it should be observed that clients are to some extent exposed to operational risk and default/financial risk, and there is some degree of asymmetric information.

- Operational risks include misdealings (eg, execution errors) and settlement errors, which are likely to be high in terms of frequency, but low in terms of impact.<sup>79</sup>

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<sup>77</sup> Based on data from FSA, also used in Oxera (2003), 'Cost-Benefit Analysis of the FSA's Policy Propositions on Soft Commissions and Bundling', April.

<sup>78</sup> The practice of bundling brokerage services (and softing) was reviewed by the FSA in 2003/04. See FSA (2003), 'Bundled Brokerage and Soft Commission Arrangements', Consultation Paper 176, April; Oxera (2003), 'An Assessment of Soft Commission Arrangements and Bundled Brokerage Services in the UK', April, and FSA (2004), 'Bundled Brokerage and Soft Commission Arrangements; Feedback on CP 176', Policy Statement 04/13, May.

<sup>79</sup> See also Oxera (2004), 'Corporate Action Processing: What Are the Risks?', May.



- With regard default risk, to the extent that client funds are segregated from those of the firm, clients do not lose in the event of default. FSA rules require such segregation, although institutional clients are given the option to agree with the brokerage firm to opt out of the segregation requirement. Institutional clients are usually able to assess the risk and may negotiate appropriate safeguards or choose lower-risk brokers for their transactions.
- Trade execution quality is notoriously difficult to measure, even on an ex post basis. An Oxera survey, undertaken for the FSA, indicates that fund managers regularly monitor the performance of their brokers, often using data provided specifically for that purpose.<sup>80</sup> Companies such as ITG, Plexus, and Elkins & McSherry have developed tools to assist, but ultimately it may be difficult to distinguish between the many and varied factors that interact to influence execution quality and performance. These factors include market conditions and luck, as well as the broker's expertise and experience.

### **Trading infrastructure (Type A)**

A.82 Trading infrastructures or exchanges are necessary for financial asset markets to operate efficiently. Their aim is to assist price formation and transparency by enabling buyers and sellers of a given asset to come together and trade, while reporting the price at which that trade takes place. In equity markets, a distinction is usually made between the primary market, where firms choose an exchange on which they list their shares, and the secondary market, where listed shares are traded among brokers. Another important aspect of the business of exchanges is the reporting function (ie, collecting information on trades that have taken place and communicating this information to market participants and other interested parties).

A.83 Various RIEs in the UK trade in different securities, including:

- the LSE and virt-x, trading in equities;
- the London Metal Exchange, trading in eight non-ferrous metal types;
- the International Petrol Exchange, trading in four major oil products; and

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<sup>80</sup> See Oxera (2003), 'An Assessment of Soft Commission Arrangements and Bundled Brokerage Services in the UK', report prepared for the FSA, April.

- the London International Financial Futures and Options Exchange (LIFFE, now part of Euronext.liffe) and EDX (owned by the LSE), trading in derivative contracts.

A.84 Debt instruments and many types of derivatives are often traded 'over the counter' – ie, not through an established trading platform. There are also alternative trading systems that do not have RIE status, but operate under the authorised-persons regime and compete for business with RIEs. One of these is OFEX, an equity trading system, where many smaller companies have chosen to list their shares.

#### COMPETITION INDICATORS

A.85 Although there are several trading infrastructures in the London market, they are broadly differentiated by purpose. Exchanges in different countries compete with each other to some extent, and this is likely to intensify under the new EU regulatory framework. The HHIs for equities and derivatives exchanges across Europe are estimated at well above 1,800, as shown in Tables A1.4 and A1.5. In other words, these markets are concentrated.

TABLE A1.4 - MARKET SHARES AND HHI FOR EQUITIES EXCHANGES ACROSS EUROPE, 2003

<i>Exchange</i>	<i>Market share by value of shares traded (%)</i>
London Stock Exchange	36.32
Euronext	19.48
Deutsche Börse	13.07
Spanish exchanges (BME)	9.39
Borsa Italiana	8.26
Swiss Exchange	6.14
Stockholm Exchange	3.05
Helsinki Exchange	1.67
Oslo Exchange	0.79
Copenhagen Exchange	0.68
Other exchanges (eight in total) <sup>1</sup>	1.19
<b>Total</b>	<b>100</b>
<b>HHI</b>	<b>2,077.16</b>

Note: <sup>1</sup> 'Other' exchanges include Budapest, Irish, Ljubljana, Luxembourg, Malta, Warsaw, Wiener Börse.

Source: www.fibv.com.

TABLE A1.5 - MARKET SHARES AND HHI FOR DERIVATIVES EXCHANGES ACROSS EUROPE, 2003

<i>Exchange</i>	<i>Market share by</i>	
	<i>Number of contracts traded</i>	<i>Value of contracts traded</i>
Euronext.liffe	37.48	77.46
EUREX	55.36	21.90
Stockholmsbörsen	3.93	0.25
IDEM (Italy)	0.97	0.24
Spanish exchanges (BME)	1.27	0.08
Others exchanges <sup>1</sup>	0.99	0.07
<b>Total</b>	<b>100</b>	<b>100</b>
<b>HHI</b>	<b>4,487.45</b>	<b>6,479.04</b>

Note: <sup>1</sup> 'Other' exchanges are otop market.at, Copenhagen Stock Exchange, Helsinki Exchange, ADEX, Budapest Stock Exchange, Oslo Bors, and WSE.

Source: [www.fese.be/statistics](http://www.fese.be/statistics).

- A.86 Barriers to entry are a significant feature in the provision of trading infrastructures. Although IT infrastructures are themselves not particularly costly to construct—particularly for firms that already operate in a market in a different jurisdiction—established exchanges have advantages in terms of their reputation and regulatory standing with financial market participants, and in particular in terms of the network externalities that arise in attracting liquidity.
- A.87 The above indicates that the competition indicators for trading infrastructures are above the threshold.

#### RISK AND MARKET FAILURE INDICATORS

- A.88 The risk, externalities and public good characteristics of trading infrastructures are sufficiently high to assess the risk and market failure indicators above the threshold. However, these risks and market failures have traditionally been addressed by the trading infrastructures themselves, which have a range of self-regulatory functions to ensure efficient market operation (as reflected in their status of recognised bodies under the FSMA).
- A.89 Operational risk caused by the exchange itself is minimal. However, one of the key drivers of regulation of trading infrastructures is counterparty risk, and many rules (including those made by exchanges themselves) are concerned with reducing counterparty risk.
- A.90 One externality in trading infrastructure is that when a market participant posts an initial order (ie, one that is not responding to an offered deal, but offering the

deal), that participant is granting a free option (to sell or buy at that price) to every other player in the market. Hence, as they are potentially vulnerable, participants offering such an option require some protection and guarantees in order to provide incentives for players to post such potential trades.

- A.91 Public goods are significant in this market because the price-formation mechanism—the central function of trading infrastructures—is designed to provide information on price formation (information that is itself a public good).

#### REGULATORY FRAMEWORK

- A.92 The regulatory framework for RIEs and its implications for competition are discussed in sections 5 and 7 of this report. Investment exchanges may choose two potential regulatory routes: to become an RIE under Section 285 of the FSMA—the option chosen by the largest exchanges; or to seek authorisation. The requirements for becoming an RIE, as set out in the FSMA 2000 Regulations 2001, include that the exchange must have sufficient financial resources; there must be adequate investor safeguards; the exchange must maintain high standards of integrity and fair dealing; adequate procedures must be in place to regulate the business of the exchange; and there must be appropriate procedures in place to deal with unsettled contracts.

- A.93 The FSMA (Chapter III of Part XVIII) excludes the regulatory provisions of RIEs from Chapter I prohibition of the Competition Act 1998. In addition, exclusions from Chapter II of that Act apply to the practices or conduct of RIEs or conduct of a person subject to the rules of an RIE, where that conduct is required by an RIE's regulatory provisions. The OFT has a duty to review the regulatory provisions of RIEs and report to the Competition Commission any significant adverse effects on competition (Chapter II of Part XVIII). The Competition Commission may refer the matter to HM Treasury.

- A.94 The rules on exchanges are also to an important extent set by EC Directives, in particular the Market and Financial Instruments Directive 2004 (and its predecessor, the Investment Services Directive). This Directive covers areas such as:

- *authorisation*—regulated exchanges are to be subject to an authorisation regime;
- *management*—the managers of a regulated exchange should be 'of good repute' and 'sufficiently experienced';
- *rules*—conflicts of interest for the exchange should be effectively managed; risks should be identified and effectively managed; contingency arrangements must be in place for systems disruptions;

rules must be transparent and non-discriminatory; and sufficient financial resources must be available to the exchange;

- *admission to trading*—there should be transparent requirements for the admission of securities to trading. Securities admitted to trading should meet their obligations;
- *access*—access to the market should be transparent and non-discriminatory;
- *transparency*—bid and offer prices should be made public throughout the trading day. The price of transactions that have taken place should be made public.

A.95 These rules broadly accord with the manner in which exchanges operate and are regulated in the UK.

### **Clearing and settlement infrastructure (Type A)**

A.96 There are several aspects to clearing and settlement. Equity and derivatives trades can be cleared by a central counterparty (CCP), which stands between the buyer and the seller in a transaction, and undertakes risk management. Settlement refers to the activities of a central securities depository (CSD), which maintains an electronic record of the holders of securities. Custodians act as an intermediary between the CSD and the investor.

A.97 LCH.Clearnet and CREST are the only two UK recognised clearing houses (RCHs) at present. LCH.Clearnet is the clearing house for the Euronext.liffe derivatives exchange, the International Petroleum Exchange, the London Metal Exchange, and a number of over-the-counter derivatives markets.<sup>81</sup> LCH Equityclear is the CCP on the LSE and virt-x, and was set up as a partnership between LCH, CREST and the LSE. CREST is the CSD for UK-issued (and Irish) shares. In 2002, it merged with Euroclear.<sup>82</sup>

### **COMPETITION INDICATORS**

A.98 Market concentration is very high, since both LCH.Clearnet and CREST are basically monopolies in their respective activities. Hence, the HHI would have the maximum of value of 10,000.

A.99 There is some potential for competition 'for the market' between clearing houses. An example is the competing offer made in 2003 by Eurex Clearing

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<sup>81</sup> The merger between LCH and Clearnet was approved by the OFT in August 2003.

<sup>82</sup> This merger was cleared by the OFT in September 2003.

(owned by Deutsche Börse and the Swiss Stock Exchange) to become the CCP on the London Stock Exchange. In principle, exchanges could also have multiple CCPs, thereby giving customers choice. However, this arrangement is likely to be less efficient because of lost scale and network effects. There is also some potential for competition between CSDs for cross-border settlement and holding of securities. This is facilitated through electronic links between CSDs, which make it possible to create 'shadow' securities (or depository instruments) in one CSD of securities originally issued in other CSDs. However, this form of competition seems unlikely to become significant in the short term, in part because of the remaining cost differences between domestic and cross-border settlement and holding.<sup>83</sup>

A.100 The market for clearing and settlement services is characterised by significant economies of scale and network effects. For example, efficient transacting requires that securities, buyers and sellers link into the same CSD. Moreover, there are fixed costs associated with holding accounts at CSDs. The combination of a single CSD holding all the shares of a particular firm and investors (or their agents) wanting to hold their portfolios in a single CSD therefore produces a market structure in which there is a single CSD that will tend to hold all the shares owned by (and traded between) a large number of investors who invest within the limits of that CSD. In other words, the market has natural monopoly characteristics.

A.101 Similar economies of scale and network effects apply to CCPs. In particular, the more trades that are cleared by the same CCP, the greater the potential for netting efficiencies. The strength of these effects can be illustrated by the history of the National Securities Clearing Corporation (the CCP in the USA, and now part of the Depository Trust & Clearing Corporation). In the 1970s, there was not a single system, but rather a number of competing systems, with consumers having a choice of where to clear and settle. However, over time, all clearing business tipped towards this CCP, which then gradually took over the other US systems.<sup>84</sup>

A.102 Overall, this market comes above the competition threshold.

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<sup>83</sup> See, for example, Niels, G., Barnes, F. and Van Dijk, R. (2003), 'Unclear and Unsettled: The Debate on Competition and Regulation in Clearing and Settlement of Securities Trades', *European Competition Law Review*, 24, 634–9.

<sup>84</sup> See Niels, G., Barnes, F. and van Dijk, R. (2003), 'Unclear and Unsettled: The Debate on Competition and Regulation in Clearing and Settlement of Securities Trades', *European Competition Law Review*, 24, 634–9.

## RISK AND MARKET FAILURE INDICATORS

- A.103 Operational risk, financial and default risk, systemic risk and negative externalities are all significant in the clearing and settlement market. For this reason, the systems themselves have traditionally performed an important regulatory role (as reflected in their current status of recognised bodies under the FSMA). Risk management is the main function of a clearing house.
- A.104 CSDs can be subject to operational risk—in particular, in the case of cross-border transactions, as systems are not always designed to interoperate.
- A.105 Financial risk is also considerable in the case of CCPs. Defaults by market participants become the responsibility of the CCP, which will then close out the open positions as efficiently as possible and make up any losses in accordance with the rules of the clearing house. On occasion, defaults of a clearing house have occurred, examples being Paris (1973), Kuala Lumpur (1983) and Hong Kong (1987).<sup>85</sup>
- A.106 At a systemic level, a CCP's exposure to risk and risk management is a significant concern because of the interrelated credit, market, liquidity, operational and legal risks that exist, and because the value of transactions is almost always very large, albeit of short duration.<sup>86</sup> CSDs embody a different sort of systemic risk. Like failure at a clearing house, failure at a CSD could suspend trading across many markets for some time. In this sense, a CSD does embody systemic risk. However, the positions taken by market participants in the settlement process are much smaller (short-term) overall, which means that the systemic risk is lower than in the case of clearing houses.
- A.107 As a result of the above considerations, the market in clearing and settlement is assessed as being above the threshold.

## REGULATORY FRAMEWORK

- A.108 The regulatory framework for RCHs and its implications for competition are discussed in sections 5 and 7 of this report. Both LCH and CREST are recognised bodies under Part XVIII of the FSMA. The recognition requirements are designed to ensure that recognised bodies regulate their clearing systems according to appropriate standards, and are set out in secondary legislation (ie, the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001).

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<sup>85</sup> Hills, B., Rule, D., Parkinson S. and Young, C. (1999), 'Central Counterparty Clearing Houses and Financial Stability', *Financial Stability Review*, Bank of England, June.

<sup>86</sup> Group of Thirty (2003), 'Global Clearing and Settlement: A Plan of Action'.

A.109 The FSA guidance on RCHs is set out in the Recognised Investment Exchanges and Recognised Clearing Houses Sourcebook of the FSA Handbook. Among the main recognition requirements set out here are that business must be conducted in a manner that promotes proper protection for investors. This includes arrangements to ensure orderly business, to limit market abuse and financial crime, and to ensure that clearing and settlement of transactions are executed in a timely and secure manner.

A.110 CREST is also subject to the Uncertificated Securities Regulations 2001. These set out the legal framework of such a system, together with the criteria that an operator such as CREST must meet. HM Treasury has the power to approve an operator, although this power has been delegated to the FSA. The OFT has powers of oversight to ensure that competition is not distorted.

A.111 In April 2004, the European Commission announced that it intends to implement a Framework Directive on clearing and settlement addressing competition-related issues.<sup>87</sup>

### **Custody services offered to institutional clients (Type C)**

A.112 Custody services typically involve safekeeping and servicing financial assets. Custodians' roles also involve collecting income, processing corporate actions, and executing applications of entitlements to reduce rates of withholding tax. Custodian services are purchased primarily by institutional investors and brokers; private clients do not purchase services directly from global custodians, but normally use their own retail broker. Fees in this market tend not to be standardised.

### **COMPETITION INDICATORS**

A.113 The market share data in Table A1.6 shows that the HHI for this industry is 951. This indicates an unconcentrated market. However, the five largest firms control 62.7% of the market, and the ten largest firms control 80% of the market. Furthermore, these are global market shares—reflecting the international nature of this market—but UK-specific market shares might be somewhat higher. In addition, the increasing trend is for greater concentration in this market. This was seen in January 2003, with the acquisition by State Street of Deutsche Bank's custody services (with \$2,200 billion assets in custody).

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<sup>87</sup> European Commission (2004), 'Clearing and Settlement in the European Union—The Way Forward', Communication to the Council and Parliament, COM(2004)312, April 28th.



TABLE A1.6 - MARKET SHARE OF WORLDWIDE ASSETS MANAGED BY CUSTODIANS (2003–04)

<i>Company</i>	<i>Worldwide assets (US\$ billion)</i>	<i>Managed directly (US\$ billion)<sup>1</sup></i>	<i>Managed as sub-custodian (US\$ billion)</i>	<i>Market share of assets (%)</i>
State Street	9,100	9,100	0	16.61
The Bank of New York	8,662	7,102	1,560	15.16
JP Morgan	8,014	7,903	111	14.16
Citigroup	6,640	1,062	5,578	11.73
Mellon Group <sup>2</sup>	2,903	2,653	250	5.13
UBS AG	2,398	n/a	n/a	4.24
Northern Trust	2,300	2,300	0	4.06
BNP Paribas Securities Services	2,167	n/a	n/a	3.83
HSBC Global Investor Services	1,572	1,432	140	2.78
Société Générale	1,329	984	345	2.35
<b>Top ten total</b>	<b>45,085</b>	<b>32,536</b>	<b>7,984</b>	<b>79.97</b>
<b>Industry total</b>	<b>56,376</b>	<b>37,931</b>	<b>8,587</b>	<b>100.00</b>
<b>HHI of 42 global custodians</b>	<b>951.1</b>			

Note: This table is based on data supplied to globalcustody.net by the service providers listed, at various dates from July 2003 to June 2004. Providers appearing in the worldwide assets column, but not in the direct management and sub-custodian columns, have not supplied a breakdown of their total figure. <sup>1</sup> 'Managed directly': assets held in the capacity of custodian (and not as sub-custodian). <sup>2</sup> Assets held on Mellon Group's network include ABN AMRO Mellon, CIBC Mellon and Mellon Global Securities Services.

Source: [http://www.globalcustody.net/uk/custody\\_assets\\_worldwide/](http://www.globalcustody.net/uk/custody_assets_worldwide/), 2004.

A.114 Furthermore, there are significant economies of scale that create barriers to entry in this market. Custodians need global access to local CSDs, either directly or through local agents ('sub-custodians'). They also require sophisticated systems and technology to offer a variety of reporting, management and processing services to their customers.<sup>88</sup> Overall, the competition indicators are assessed as above the threshold.

#### RISK AND MARKET FAILURE INDICATORS

A.115 Operational risk is the most significant issue on the market failure/risk indicators. The high volume of processed transactions for global custodians leads to a substantive risk that losses may be caused by inadequate or failed

<sup>88</sup> See, for example, BIS (1995), 'Report on Cross-Border Securities Settlements', March; and Comptroller of the Currency Administrator of National Banks: Custody Services (2002), *Comptroller's Handbook*, January.

internal processes, and human or system errors. These risks feed through into a relatively high level of default risk, which is also enhanced by the undertaking of stock lending. Operational risks also arise in the processing of corporate actions.<sup>89</sup>

A.116 However, institutional clients of custody services are usually informed financial professionals, and many of the risks mentioned above can be effectively contracted for. Market failures such as negative externalities and asymmetric information are not significant. Overall classification of the market on the basis of these indicators is therefore below the threshold.

#### REGULATORY FRAMEWORK

A.117 Firms undertaking custody services require authorisation. The FSA rules for custody services are contained in the Conduct of Business Sourcebook and the Client Assets Sourcebook of the FSA Handbook. These rules relate to the management of conflicts of interest, and require that written confirmation of transactions be provided to clients; that adequate protection be provided for clients' assets while in the firm's custody; and that firms follow the FSA's Principles of Business.

A.118 The capital requirements for custodians are that they hold own funds of 125,000 euros and liquid funds of 13 weeks of their annual audited expenditure, as well as weighted requirements for various risks.

#### **General insurance services for private customers and SMEs (Type B)**

A.119 General insurance provides a means for the insured to cover themselves against potential losses arising from specific events. The general insurance market in the UK is approximately equally split between personal and business insurance.

A.120 General insurers face liabilities from the insurance policies that they have written and have to make technical provisions for these. As underlying claims take longer to be reported and settle than in the life assurance industry, technical provisions are large for general insurers.

A.121 There are two sources of income for general insurers: their underwriting business, and from investing premium income to meet future liabilities and receive investment income. This reflects the time lag between receiving premium income and settling claims.

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<sup>89</sup> Oxera (2004), 'Corporate Action Processing: What are the Risks?', May, p. 14, report prepared for the Depositary Trust & Clearing Corporation, available at [www.oxera.com](http://www.oxera.com).

## COMPETITION INDICATORS

- A.122 The level of concentration in the personal insurance market is low: the largest player (Norwich Union) has a 14.7% market share,<sup>90</sup> while the HHI is in the range of 440 to 550. Similarly, the HHI for the property insurance market (part of the personal insurance market) is in the range of 650 to 740, once again low.
- A.123 Although entry barriers exist in this market, they are not onerous, and relate to the ability to acquire expert staff and access to sufficient capital to engage in underwriting. Similarly, in relation to direct sales forces, there would be greater economics of scale because of the availability of insurance brokers as a distribution channel. There is a substantial market share held by overseas firms in the UK general insurance market (38.3%),<sup>91</sup> and, given fixed policy terms in insurance, switching costs are likely to be limited to those caused by an existing insurer being better able to assess an individual's claims history.
- A.124 The market for general insurance services for private customers and SMEs thus falls below the competitive indicator threshold.

## RISK AND MARKET FAILURE INDICATORS

- A.125 Insurance firms face significant financial risk in their investments, which are likely to include both equities and bonds. In addition, general insurers face the default risk that a reinsurer might refuse to settle a claim where a dispute arises over the liability and allocation of losses.
- A.126 Furthermore, there is substantial asymmetric information in this market when choosing an insurer because it is difficult for policyholders to assess the adequacy of an insurer's controls or investments; and the extent to which risks have been laid off with reinsurers. However, in terms of product offering, products tend to be transparent and well understood by consumers, and there is a degree of standardisation in the market, so asymmetric information is much less significant in this area.
- A.127 The general insurance market for private customers and SMEs is above the threshold as regards risk and market failure.

## REGULATORY FRAMEWORK

- A.128 As general insurance is a regulated activity, general insurers need to be authorised. They are thus subject to the supervisory, investigatory and disciplinary powers of the FSA, as granted in the FSMA. However, general

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<sup>90</sup> Datamonitor (2004), 'UK Personal General Insurance 2003/04'.

<sup>91</sup> International Financial Services London (2004), 'Insurance', City Business Series, p. 3.

insurance has not to date been subject to FSA's Conduct of Business requirements in terms of sales, advice and service standards. Instead, the General Insurance Standards Council (GISC) operates regulation, primarily through the Private Customer Code and the Commercial Code. Membership of the GISC is voluntary, although this is set to change from January 15th 2005, when responsibility for conduct of businesses regulation will transfer to the FSA from GISC.

A.129 From January 15th 2005, the FSA will also implement the Insurance Mediation Directive,<sup>92</sup> which will result in the transfer of the regulation of general insurance intermediaries from the GISC to the FSA. Among the major conduct of business provisions are that firms must know their customers and disclose information about risks and charges; that firms must disclose all information regarding features of packaged products; that claims must be handled promptly and fairly; and that firms must disclose details of insurance intermediaries and their relationship with the insurer. In addition, prudential requirements will apply, which include the level of capital to be held by insurance intermediaries and the treatment of client money.

A.130 The FSCS protects customers of authorised insurers against default in the case of insolvency of an insurer. Unused insurance premia are refunded at a rate equal to the whole of the first £2,000, plus 90% of subsequent premia.

A.131 The Integrated Prudential Sourcebook sets capital requirements for general insurance which are based on EC requirements. A firm must hold the higher of two calculations:

- the first calculation is 18% of gross premia up to 50m euros and 16% of gross premia in excess of 50m euros;
- the second calculation is based on an annualised figure for the gross claims of the previous three financial years. The calculation is 26% of that figure up to 35m euros, and 23% of that figure in excess of 35m euros.

A.132 Both these calculations may be reduced for reinsurance up to a maximum of 50%. Insurers are not limited in the assets in which they may invest.

### **Life assurance services for private customers (Type B)**

A.133 Life assurance products are held for two purposes: unit-linked and with-profits insurance products are mainly held for savings, although they also contain a life

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<sup>92</sup> Directive 2002/92/EC.

assurance element; protection products, such as critical illness or term assurance, do not contain a savings element, as it is not certain that a payment will be paid at any point, rather payments are conditional on an event occurring. Life assurance products can also be held for capital repayment purposes (eg, mortgage endowment policies), to provide for retirement (eg, pension) or to provide an income (eg, annuities).

#### COMPETITION INDICATORS

A.134 In 2002, there were 160 UK authorised life assurance companies with an additional 54 companies authorised as composite insurance companies, which provide both life and general insurance.<sup>93</sup> Table A1.7 reports net income premiums for the ten largest net income-generating insurance companies in the UK. It also shows that the HHI in this market was between 530 and 650.

TABLE A1.7 NET UK PREMIUM INCOME AND MARKET SHARES, 2002

<i>Company</i>	<i>Long-term net premium income (£m)</i>	<i>Market share (%)</i>
Barclays Life	11,836	12.3
Standard Life	9,590	9.9
Norwich Union	8,626	8.9
Prudential plc	8,350	8.6
HBOS plc	6,181	6.4
Scottish Widows	5,494	5.7
Legal & General Group plc	4,220	4.4
Zurich Financial Services	3,719	3.9
AXA Insurance plc	3,520	3.6
AEGON UK plc	3,212	3.3
Others	31,852	33.0
<b>Total</b>	<b>96,600</b>	<b>100.0</b>
<b>HHI high</b>		<b>643.4</b>
<b>HHI low</b>		<b>534.7</b>

Notes: HHI high is based on assuming that the share of 'others' in this market is allocated equally between ten companies such that their market share is just below that of AEGON UK plc in the above table. HHI low assumes that an infinite number of participants account for the share of 'others', each with market share close to zero.

Source: Datamonitor (2004), 'UK Life Assurance 2004: Summary', April.

<sup>93</sup> International Financial Services London (2004), 'Insurance', City Business Series, January.

A.135 Countervailing buyer power is limited, as is usually the case in retail markets, and switching costs are high due to the nature of life assurance policies, although there is a limited second-hand market, which will ease switching. There is little evidence of substantial overseas entry into this market, with most of the major players remaining domestic, although some foreign firms have established UK-based subsidiaries.

A.136 Overall, the market for life assurance services for private consumers is assessed as being below the threshold for competition indicators.

#### RISK AND MARKET FAILURE INDICATORS

A.137 The most significant problems in this market are those relating to operational risk, financial and default risk, and asymmetric information. Operational risk occurs in a range of ways: transaction processing, record maintenance, and settlement and custody activities. Financial and default risk is inherent in any product that holds volatile underlying assets, including bonds which may themselves be defaulted upon; while the pricing of life assurance products requires a high level of expertise.

A.138 Asymmetric information is high for life assurance products. Such products are sophisticated and have a high degree of product differentiation. Different life assurance funds may exhibit very different performance. Furthermore, the relative performance of the underlying fund is not observable by consumers, and therefore the level of risk exhibited in the underlying assets also cannot be assessed.

A.139 The market for life assurance services for private consumers is thus assessed as being above the threshold as regards risk and market failure indicators.

#### REGULATORY FRAMEWORK

A.140 All insurance contracts are regulated under the FSMA. Some protection products—for example, term assurance products of less than ten years' duration—are not considered investment products, and are therefore not regulated by the FSA in terms of the conduct of business. Investment-type insurance is considered to be a financial investment, and is therefore covered by the Conduct of Business Sourcebook. However, from January 15th 2005, all non-investment insurance will also be regulated by the Insurance Conduct of Business Sourcebook, which will include provisions that firms must know their customers; disclose all information regarding the features of packaged products; handle claims promptly and fairly; and disclose details of insurance intermediaries.

A.141 The Integrated Prudential Sourcebook prescribes risk-based capital requirements.

### **Insurance services for large business customers (Type D)**

A.142 The large business insurance market differs in a number of ways from the general insurance services market for private customers and SMEs. Importantly, large businesses can set aside reserves for themselves to cover potential losses and put these into 'captive' offshore insurance companies. Captives can help large businesses provide for potential losses, independently of insurance companies.

#### **COMPETITION INDICATORS**

A.143 It is difficult to find data for the large business market separately from the insurance market for SMEs. As large firms have more avenues to acquire insurance—including directly through Lloyd's and the company market, and via captive insurers—it would seem most unlikely that concentration in this market is higher than in that for private consumers and SMEs. Entry barriers are similar to those in the general insurance market for private consumers and SMEs, and arise from the need to have expert staff and attract capital.

A.144 The main difference between the general insurance market for private consumers and SMEs and the market for insurance to large businesses is that countervailing buyer power is considerably higher in the latter. Large firms may have dedicated risk management staff, and the ability to set up captive insurers will limit any attempt by suppliers to raise prices. Furthermore, large companies are more likely than small firms to be able to source insurance services from overseas.

A.145 The market for insurance services for large business customers is assessed as being below the threshold as regards the competition indicators.

#### **RISK AND MARKET FAILURE INDICATORS**

A.146 The most significant risk factor for the market for insurance services for large business customers is operational risk, in particular in the processing of transactions and record-keeping. There are also some financial risks, including interest rate risk and the risk of default on the underlying assets. However, most of the elements of the risk and market failure assessment are considered low. In particular, the asymmetric information that is prevalent in the market for general insurance to private consumers and SMEs is likely to be less of a problem in this market because of the presence of specialist staff within large business customers and the ability to retain brokers or consultants to advise the large firms. This applies both to the availability of product offerings and the

quality of the products. Systemic risks and negative externalities are all either limited or non-existent in this market.

A.147 The market for general insurance to large businesses is therefore below the threshold for risk and market failure indicators.

### **Reinsurance services (Type D)**

A.148 Reinsurance is a means by which direct insurers can transfer risks emanating from insurance policies written for the policyholders. The broad objective of reinsurance is to spread risks and protect a direct insurer from undue volatility in annual losses from underwriting and losses from catastrophic events. The reinsurer has no direct contractual relationship with the insured.

A.149 There are five primary functions of reinsurance: to provide flexibility for insurers in the size, level of risk and volume of business they can underwrite; to provide assistance in specialist areas; to assist insurers in limiting large fluctuations in underwriting results; to assist in financing insurance operations which would otherwise require an increase in an insurer's capital; and to provide protection against large claims that can result from catastrophic events.

### **COMPETITION INDICATORS**

A.150 The reinsurance market is global and it is therefore difficult to obtain data on reinsurance of UK risks, as opposed to risks reinsured in the UK.. However, the market seems unconcentrated. Table A1.8 provides data on net reinsurance premiums written from the UK. Excluding Lloyd's—which is a market rather than an individual reinsurer—the HHI for reinsurance written from the UK is 925.6, below that which would be a cause of concern. These figures do not include any reinsurance of UK risks undertaken overseas and may include overseas risks reinsured from the UK.



TABLE A1.8 - LARGEST REINSURERS BY NET PREMIUMS WRITTEN, 2002

<i>Company</i>	<i>Net reinsurance premiums written (\$m)</i>
Lloyd's	6,808.6
GE Frankona Reassurance Ltd	747.9
QBE International Insurance Ltd	658.8
Swiss Re Co. (UK) Ltd	452.7
Aspen Insurance UK Ltd	320.0
General Cologne Re UK Ltd	246.8
Markel International Insurance Co. Ltd	223.2
St. Paul Re Co. Ltd	211.8
Alea London Ltd	193.7
Faraday Re Co. Ltd	178.1
Brit Insurance Ltd	175.8
SCOR UK Ltd	167.0
Gerling Global General & Re. Co. Ltd	145.7
World-Wide Reassurance Co. Ltd	73.5
Hannover Life Re (UK)	69.9
Great Lakes Re (UK) PLC	53.1
Liberty Mutual Insurance Co. (UK) Ltd	44.1
Gerling Global Life Reassurance Co. (UK) Ltd	29.9
NGT Insurance Co. (Isle of Man) Ltd	25.2
Kyoei Mutual Fire & Marine Insurance Co. (UK) Ltd	1.3
Endurance Worldwide Insurance Ltd.	0.1
CX Re. Co. Ltd	-82.6
<b>Total</b>	<b>10,998.3</b>
<b>Total excluding Lloyd's and CX Re. Co. Ltd</b>	<b>4,272.3</b>
<b>HHI (excluding Lloyd's and CX Re. Co. Ltd.)</b>	<b>925.6</b>

Notes: The table refers to net premiums written from the UK, which could include premiums written for overseas risks. In addition, premiums written overseas for UK risks are not captured in the table, and Lloyd's is composed of a number of market participants rather than being a single company.

Source: Standard & Poor's (2003), 'Global Reinsurance Highlights', A Reactions publication, 2003 Edition.

A.151 There is a degree of buyer power in this market, as buyers are institutions that are informed players in the market. Switching is facilitated by the presence of insurance brokers in this market, although long-standing working relationships between an insurer and a reinsurer may lead to a switching cost. There is little vertical integration in this market.

A.152 More significant is the evidence of economies of scale, which may arise through the availability and cost of capital. Similarly, entry into this market requires capital and a high degree of expertise, both of which may act as barriers to entry.

A.153 Taking all the indicators into account, this market falls below the threshold for competition indicators.

#### RISK AND MARKET FAILURE INDICATORS

A.154 The two most important elements in this part of the assessment for the reinsurance market are operational risk and asymmetric information. Operational risk is similar for reinsurers as for other insurance firms, and arises from risks such as the failure of internal controls to ensure compliance and the need to ensure efficient processing of transactions. Again, these risks are significant.

A.155 Asymmetric information is, unusually for an institutional market, also somewhat significant. It is difficult to assess the performance of reinsurers in several areas. Among these are the adequacy of internal controls; the appropriateness of the investment strategy which the reinsurer is adopting; and whether technical provisions are sufficient.

A.156 Systemic risks may also be present in this market to some extent, although it is difficult to make an overall assessment in this regard as the industry is relatively opaque. There does, however, seem to be the potential for the failure of one reinsurer to have an impact on other reinsurers to which they have ceded risks, although such failures have been rare.

A.157 This market is assessed as falling just below the threshold for risk and market failure indicators.

#### **Insurance services by Lloyd's of London (Type D)**

A.158 The functions performed at Lloyd's of London, namely general insurance and reinsurance, are also covered more broadly in other parts of this appendix. Lloyd's warrants an additional individual assessment for several reasons, including the fact that Lloyd's is addressed specifically in the FSMA (Part XIX) and the fact that making an assessment of market concentration and risks in the broader UK-based reinsurance sector also requires an assessment of Lloyd's.

A.159 In January 2004, there were 66 syndicates, in the form of groups of individual or corporate members, who underwrote insurance risks at Lloyd's.<sup>94</sup> There were also 45 managing agents who run the syndicates. Syndicates are required to

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<sup>94</sup> International Financial Services London (2004), 'Insurance', City Business Series, p. 13.

deposit with Lloyd's a proportion of the premiums earned, which is placed in a central fund that can be used to pay unsettled claims. Lloyd's is a co-insurance market, with more than one syndicate underwriting a particular insurance risk. In addition, the link between clients, who want to place insurance risks, and insurers is provided by accredited brokers. As of June 2004, there were 167 firms of brokers working in the Lloyd's market.

A.160 Corporate members now largely dominate Lloyd's., Lloyd's data suggests that in January 2004 there were 752 corporate members providing £13,092m worth of capital (87.5% of the total) and 2,048 individual members providing £1,869m (12.5%).

#### COMPETITION INDICATORS

A.161 Lloyd's operates in a global market for insurance. Syndicates at Lloyd's compete against each other, and against underwriters independent of Lloyd's and overseas insurance and reinsurance providers. In terms of the global non-life assurance market, for example, the London market's share is around 3%, although 10–15% for large industrial business risks.<sup>95</sup> However, Lloyd's expertise in insuring unusual risks means that it may have a higher market share in that segment of the market. In terms of market shares of syndicates at Lloyd's, data on syndicate capacity—the maximum premium income that the syndicate can receive in aggregate—is available on the Lloyds of London website.<sup>96</sup> This suggests that the market has low levels of concentration, with an HHI of 249 for 2002. While the number of syndicates has fallen over time, this suggests that this is a market where concentration is low.

A.162 Entry into the market requires authorisation from Lloyd's and the FSA, and recent entrants have in general been large corporations, indicative of a need for high levels of expertise and capital. On the other hand, the market capitalisation of smaller Lloyd's insurance companies is relatively small. Economies of scale seem to be present in this market, as evidenced by the fall in the number of syndicates, and the recent entry of corporate members. On the other hand, actual levels of market concentration are still low. In addition, there could be thought to be countervailing buyer power in this market, as buyers are institutions that are financially sophisticated. Switching is also facilitated by the presence of insurance brokers in this market, although switching costs could exist if there are long-standing working relationships between the client and/or broker and the insurer.

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<sup>95</sup> Ibid.

<sup>96</sup> <http://www.lloyds.com>.

A.163 Taking all the indicators into account, this market falls below the threshold for competition indicators.

#### RISK AND MARKET FAILURE INDICATORS

A.164 In common with other insurance markets, Lloyd's is exposed to operational risks, although controls are in place to reduce these risks. For example, Lloyd's Operations Department and Franchise Board attempt to control and identify these risks in current operations and in business plans for prospective market participants.

A.165 In terms of financial and default risk, there is inevitably a risk that syndicates, or reinsurers to which they have ceded risks, would be unable to meet claims. On the other hand, Lloyd's operates a central fund to which syndicates are required to contribute. This all suggests that these risks are high enough to have warranted corrective action, such as the creation of the central fund, but that systems would also seem to be in place to deal with such risks.

A.166 In terms of asymmetric information, the Lloyd's market is made up of counterparties who represent clients or intermediaries. However, intermediaries are not participants in this market and it can be expected that counterparties are informed about product offerings. The larger, more sophisticated, buyers are likely to be able to monitor quality and performance.

A.167 Taking all this into account, this market falls below the threshold for risks and market failures.

#### REGULATION

A.168 Lloyd's is regulated by the FSA under Part XIX of the FSMA. In practice, this means that the FSA exercises a supervisory role and can delegate responsibilities to the Council of Lloyd's, as formalised in Section 314. Managing agents are also regulated entities, although syndicates and members are not. Alongside this, Lloyd's is an authorised body with the permissions set out in Section 315 of the FSMA, and is subject to threshold conditions in Schedule 6, with the exception of restrictions on corporations. Among other requirements, this stipulates that there should not be restrictions on the FSA's effective supervision of the firm.

A.169 Furthermore, Lloyd's is subject to the same rule-making powers of the FSA (under Part X of the FSMA), the investigatory powers of the FSA (Part XI), and the disciplinary powers of the FSA (Parts XII, XIV, XV and XVI). Regulation of Lloyd's by the FSA also specifies the delegation of regulatory functions to the Council of Lloyd's. The FSA is required to monitor this delegated authority

through annual reviews, but also through open communication with the Council of Lloyd's.

## GLOSSARY

ABI	Association of British Insurers
AIMA	Alternative Investment Management Association
AIRP	Association of Independent Research Providers
APCIMS	Association of Private Client Investment Managers and Stockbrokers
BBA	British Bankers' Association
BVCA	British Association of Venture Capitalists
CBA	cost-benefit analysis
CCP	central counterparty
CIS	collective investment scheme
CSD	central securities depository
EEA	European Economic Area
FOS	Financial Ombudsman Service
FSA	Financial Services Authority
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
FSPP	Financial Services Practitioner Panel
GISC	General Insurance Standards Council
HHI	Hirschmann-Herfindahl index
ICVC	investment company with variable capital
IFA	independent financial adviser
IMA	Investment Management Association
IPE	International Petroleum Exchange
IPO	initial public offering
IUA	International Underwriting Association of London
LCH	London Clearing House
LIBA	London Investment Banking Association
LIFFE	London International Financial Futures and Options Exchange
LME	London Metals Exchange
LSE	London Stock Exchange
M&A	mergers and acquisitions
NAPF	National Association of Pension Funds
OEIC	open-ended investment companies
OFT	Office of Fair Trading
RCH	recognised clearing house
RIE	recognised investment exchange
RSP	retail service provider
SIB	Securities and Investment Board
SME	small and medium-sized enterprise
SRO	self-regulatory organisations
UCITS	Undertakings for the Collective Investment of Transferable Securities
UKLA	UK Listing Authority