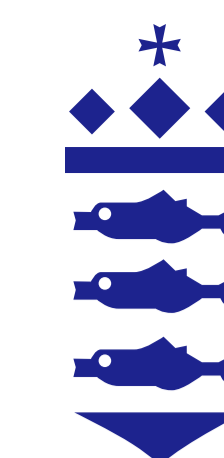




COLONIA FINANCIAL
SERVICES COMMISSION

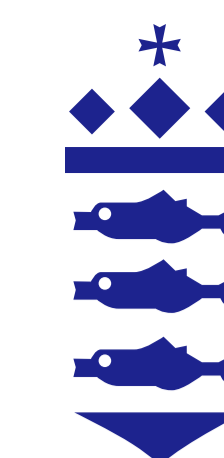
A guide to financial services regulation in Colonia

The CFSC is the regulatory body for the
finance sector in Colonia St John.



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1.1 About this document

Regulators such as the CFSC are necessarily creatures of statute. Without statute law to back them there could be little certainty that any market participants would take notice of what they said. Other market participants would worry legitimately that they bore the costs of compliance when their competitors might not. Their customers and potential customers could have no confidence that the protection apparently offered by regulation was effective.

One drawback of statutory backing is that the law is not expressed in easy to understand form. It creates institutions, powers, rights and obligations but there is neither the legislative resource nor time to explain why the regulatory regime has been created, how it is intended to operate and what its scope and limits are.

This document seeks to help fill that gap. It is intended to clarify and explain regulation in a non-legal way. It does not override the law. It is not set in stone. It is a living document that may be expected to evolve over time. Its authors certainly have not thought of everything. The innovative nature of the markets we set out to regulate never cease to surprise. The Commission would welcome feedback at any time on its content.



1.2 Serving the public interest

The Commission serves the public interest by improving the way the financial markets work in Colonia by intervening in them with the rules it creates and the supervision of licensees operating in those markets. It seeks to act in a proportionate and targeted way. It recognises that the public interest calls for a balance to be struck between protection from unfair practices and outcomes and the undue restriction of choice and affordability.

1.3 Transparency and accountability

Public bodies are required to be transparent and accountable. This document seeks to enhance the statutory requirements by making more accessible what the Commission is trying to do and how it is trying to do it. The Commission may then be judged against a clearer yardstick.

Nevertheless, there are practical limits to the amount of transparency that can be achieved. Licensees require confidentiality to protect their commercial and intellectual property from their competitors. So most of the Commission's dealings with licensees must be kept private. The principal exception is where it is in the public interest to name firms and individuals who have been found to have done wrong in enforcement proceedings.

1.4 Framework for strategic decisions

Regulators can operate at several levels when they intervene in financial markets. They may operate at the level of the individual practitioner, for example to authorise them, at the level of the licensee, at sectoral level and they may operate internationally. This document seeks to provide at least background and some of the framework for making strategic decisions, typically those affecting whole sectors or internationally affecting all financial services in Colonia.

1.5 Reasoning behind our work

At whatever level a decision needs to be taken there needs to be the reasons recorded for that decision to provide part of what is termed the "audit trail". Many decisions are necessarily taken under varying degrees of uncertainty. More time taken will often make a position clearer but at the expense of action taken too late. Regulators do not have the luxury of infinite time to take the correct decision. The Commission relies on the experience and expertise of its staff to get as many decisions right as possible. It also has an escalation process for the tougher and bigger decisions. This document is intended to provide some general understanding about how and why decisions will be made the way that they are.

1.6 The tools we use to do it

Set out at Section 4 are some of the tools we use to take operational and strategic decisions.



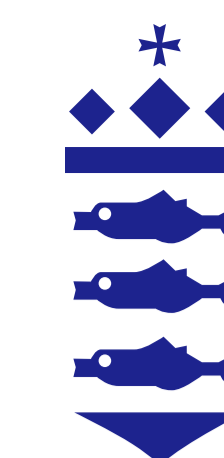
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2.1 Why regulate at all?

Some free spirits may wonder why there should be any regulation of financial services. First, it should be recognised that regulation pervades much of our lives in the public interest. We want to know the aircraft we fly in is airworthy and the pilot competent. Likewise that the ferry is seaworthy. We want nuclear power to be safe and the food we eat to be wholesome. These are obvious. Financial services is less obvious. Some of the same reasoning applies but there is additional reasoning for financial markets.

An overarching reason is so called “information asymmetry”. Few of us are knowledgeable nuclear or food scientists, we must rely on regulation. Equally, few of us can tell whether the bank at which we deposit our savings is solvent now and is likely to be in the future. Many risks in other regulated industries are independent of one another. A pilot makes an error but it does not follow that all pilots will. In financial services, risks may be systemic: that is a failure in one place can lead to failure in another. The banking crisis of 2008 well illustrates the point. Financial regulation addresses systemic as well as idiosyncratic risk.

A further characteristic of financial services is their potential duration. A long term savings or investment product may have a long period of latency. It may be many years before it is discovered that a serious problem exists. Financial services are also abstract. Many are effectively a promise to pay at some future date. The terms are expressed in a contract, the enforceability of which will depend on the standing of the counter party possibly many years in the future. Economists see this as an aspect of so-called “power asymmetry”. In short this refers to the financial institution being big with strong knowledge of its products while its (retail) customer is small and with less knowledge. (It follows that in wholesale markets where the counter party may be similar in size that regulation will be somewhat different with a bias towards systemic risk rather than one party suffering at the hands of another.)



2.2 Promoting confidence in the financial services markets in Colonia

Markets depend on confidence to work at their best. Economic prosperity depends on market confidence.

Regulating financial markets effectively and proportionately enables not just the Colonia own (virtual) inhabitants but businesses and individuals internationally to have confidence in Colonia.

Where projects are internationally mobile one aspect of the final location choice will be confidence that it will be stable and predictable. Proportionate, well-considered, regulation contributes significantly to the stability and predictability that creates confidence. Liberal democracies have adopted the approach that free markets work in the best interests of society.

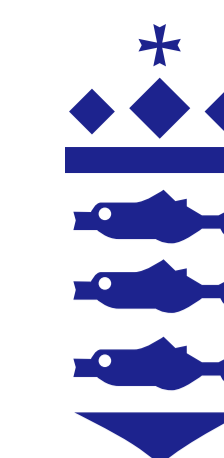
However, free markets do not always achieve these aims. There may be too few players who become dominant and reduce the benefits of competition. Equally, there may be too many resulting in inadequate revenues and corners being cut to control costs. The Commission considers the consequences of competitive forces in action. It intervenes where it sees those consequences driving inappropriate conduct that will either do harm to customers or to the reputation of Colonia more generally.

2.3 Preventing financial crime

International efforts to detect and prevent financial crime have grown considerably in recent years as the threat level has grown.

As an international financial centre in good standing, Colonia is expected to play its full part in those international efforts. It does so by embracing the international standards set and contributing to international efforts to counter money laundering, terrorist financing and the financing of weapons of mass destruction.

It does so in co-operation with other agencies in Colonia.



2.4 Protection of customers where normal market conditions cannot apply

The Commission expects customers to play their proper role in the market by acting diligently when they come to make decisions about financial services. This is not to discount the wider public policy issues of financial inclusion and education but our expectation is that in acting diligently individual customers use their knowledge and understanding of finance and risk when identifying what products they should use or invest in. Nevertheless, compared with tangible goods, financial services are harder to judge and compare. Judging the price and quality of fresh food, for example, is relatively easy compared with, say, retirement savings products.

A retirement savings product will require more decisions over a long number of years compared with a single purchase of fresh food. Customers may become vulnerable during their lifetimes, for example because of learning difficulties, old age or infirmity. Where financial markets display these asymmetries the Commission will intervene to create requirements typically to facilitate customer decision making or to control the outcomes from the decisions they actually make.

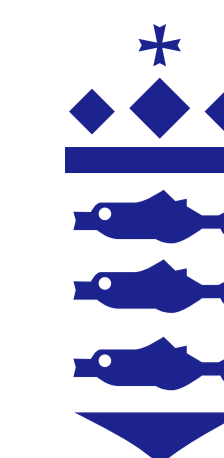
2.5 Protecting financial stability

The financial crises of 1929 and 2008 illustrate starkly what can happen when market forces, abetted by lax public policy, are left to run their course.

The reduction in prosperity and the hardship caused last well into the following decade. A society the size of Colonia would appear to have little choice but to take the consequences of what the biggest economies do, or rather, fail to do.

Colonia should simply ignore events elsewhere and simply wait for them to unfold. Indeed, Colonia often acts as a host for some parts of multinational groups and is therefore very connected with external economic events.

The Commission will play a full part in relevant international fora both to influence outcomes where it can and gain the best and earliest understanding of events on the horizon so that any mitigating measures available may be taken in good time.



2.6 Creating incentives (and disincentives) to promote desired market behaviours

Much regulation is about ensuring that only people and institutions with the right behaviours are allowed to operate in regulated markets.

The key tools regulators use are barriers to entry, such as a “fit and proper” test for individuals, and monitoring through the supervision processes that the standards set in rules are met.

Those tools will not always work, not least because the public interest is not best served by a “zero failure regime” which would eliminate all risk at the expense of all else. In consequence, the Commission has enforcement powers and exercises them where there is evidence that behaviours contrary to the rules are occurring.

Enforcement investigation does not inevitably lead to sanctioning. Investigation may uncover different evidence or reveal a situation that falls short of the need to punish. Such cases will revert to supervision for a solution. Such judgements will be based on experience, expertise and an application of the proportionality concept.



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3.1 Regulation is not free

The Commission is acutely conscious that regulation is a cost. Licensees pay fees which are set by a transparent process. However, the cost of those fees is likely to be passed on to customers through higher prices and it is legitimate that this should happen. In consequence the Commission, along with other stakeholders, must consider whether the benefits of regulation outweigh its costs to those who ultimately bear them.

3.2 Hidden costs

The costs of regulation are not simply the direct and transparent ones. It is generally acknowledged that there are varying degrees of indirect costs. Licensees initially bear the costs of compliance although these too will tend to be borne ultimately by customers. There are also frictional costs since licensees and market entrants bear the extra burden of considering regulatory implications when contemplating market entry, new products and changes to their business models. There are also price and choice implications for customers caused by restricting entry to the market of businesses that do not meet the authorisation standards applied.

There is no hard and fast way of reaching an optimal judgement about the costs and benefits of any aspect of regulation. Regulation must be affordable and achieve a reasonable balance between cost and risk.



3.3 Non-zero failure regime

Financial services regulation in the liberal democracies does not seek to produce an outcome where no institutions ever fail. This is because to do so would result in such intense regulation, both in terms of standards and supervision that the cost to the customer would be unacceptable both in direct cost terms and through reduction in choice and availability. In consequence, market participants, including customers, must accept that there is some risk of failure. They should exercise prudence accordingly. If an offer is too good to be true it probably is. For its part, the Commission will endeavour to strike the right balance, given prevailing market conditions, between the customer detriment arising from loss and that arising from lack or loss of choice and affordability. This may mean that licensees find regulatory requirements rise in times of greater risk. The Commission will also publish information where it is practical to do so to warn customers of heightened risk.

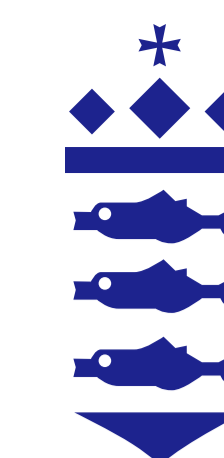
3.4 Limit of awareness

A regulator will receive a wide range of information on the firms and individuals who are authorised by it, however, as in any industry there are individuals who knowingly or unknowingly avoid regulation. This can lead to firms or individuals carrying out activities illegally without any controls or protection for customers.

By their very nature a regulator may have limited awareness of these firms or individuals but when we do identify that illegal business is occurring, through either our normal regulatory processes, intelligence gathering, third party notifications or whistleblowing we will look to take effective action.

3.5 The risk to innovation

Regulation by its nature will sometimes frustrate innovation. New products and new ways of servicing customers may not have been envisaged when the current rules were introduced. Not getting in the way of good innovations serves the public interest and the Commission has no wish to stand between the public and good innovation. But equally, an innovation may not be intended to be good. It may even have good intention but its authors failed to spot what wrong doers could do with it. Regulators have the difficult task of seeing what others have failed to see either to block an innovation with bad intent or one likely to be misused. The Commission will endeavour to make the right calls when presented with innovations. It encourages innovators to contact it early in their planning. It will do its best to allow in the good and root out the bad but over time it is likely to become apparent that it has made mistakes in both directions. This is a fair and inevitable price to pay for serving the public interest.



3.6 International overview

As an international financial centre Colonia must have regard to the rules of other jurisdictions if it wants to trade openly with them. There is also growing momentum toward the setting of standards at the global level through the work of the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Group of International Finance Centre Supervisors (GIFCS), the International Organisation of Pension Supervisors (IOPS) and the Financial Action Task Force (FATF). The Commission makes a substantial investment of staff time to understand these developments and make representations on behalf of Colonia. In large-scale multi-lateral discussions Colonia's voice will not often prevail. The consequent task of the Commission is to establish the costs and benefits of adopting international standards or those of a major bloc such as the European Union or United States. Sometimes, the price to be paid for international access to markets will be adopting standards Colonia in isolation would not need. The merits will be decided in each case following consultation with the relevant stakeholders in Colonia.



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4.1 Prioritisation

The Commission supervises licensees of varying scale and complexity. They present a wide range of risks to the public interest and their impact will vary from severe to negligible. Clearly, a systematic approach is required to allocate resources to the management and mitigation of these risks and the International Monetary Fund expects jurisdictions to have such an approach. Once authorised the Commission uses a system called the Probability Risk and Impact System (PRISM) which is also used by the European Central Bank and the Central Bank of Ireland to supervise licensees.

PRISM accords each licensee an impact rating and resources are allocated in proportion to that rating. In addition PRISM can identify general or sectoral trends and themes. These can provide early warning of potential forthcoming difficulty. That may cause priorities to change directly and it can also cause specific sectoral information gathering by means of a thematic review. In determining its activities, the Commission will make use of the data it receives to ensure that firms exhibiting higher risk characteristics can be targeted. Whatever the source of new information, the risk rating can be varied to take that information into account.



4.2 Consistency and oversight

All applications made to the Commission to carry out regulated activities within Colonia are assessed against the minimum criteria for licensing set out within the individual sector laws. Where an application is complex or otherwise challenging an assessment panel may be held to assess the information provided and make a recommendation on authorisation. PRISM is an aid to decision making: it does not take the decisions. Individual supervisors make decisions either acting alone or in conjunction with colleagues. PRISM itself introduces a significant degree of consistency but further measures are taken to improve decision making. As part of the supervision process Risk Governance Panels are convened to validate supervisory decisions. These are essentially meetings which assemble more senior staff to scrutinise decisions to ensure consistency across licensees and, where necessary, sectors. The Board of the Commission also keeps a “heat map” produced by PRISM under regular review and can examine the risk ratings of the licensees assessed as presenting the highest risk.

4.3 Identification of need

Identification of the issues involved is the first step in the decision making process. Where these come from within the licensee they will be fed into PRISM either directly through the reporting portals or by the supervisor following engagement with the firm.

Nevertheless, the business environment of the licensees can be a significant factor and is not generally a reporting matter. The Commission operates a multi-lateral review system to ensure such factors are identified. The supervisory division heads provide periodic environmental assessments for their sectors to the Board. The Commission's Director of Financial Stability produces regular assessments of global financial trends as they affect Colonia. Those Commission staff serving on the committees of international bodies report information gathered at those meetings. There are various regulatory gateways in existence based on memoranda of understanding which can provide the conduit for relevant information from other regulatory authorities.

4.4 Diagnostic assessment

All these sources are weighed and factored into the overall judgements about the need for action. There are a number of steps we can take where we consider action may be required. We can work with individual licensees to understand how an issue affects them. We may engage with an entire sector either at trade body level, by means of publishing a discussion paper or through thematic reviews to gather information more directly relevant to licensees in Colonia. PRISM can be used to produce diagnostic data and indicators about sectors. We may also use investigation powers to ascertain what individual licensees may be doing or not doing.



4.5 Remediation

Where the assessment leads to the conclusion that some form of intervention is required multi-lateral interventions are available to the Commission. Most typically, the Commission will engage with an individual licensee using a risk mitigation programme to list risks to be remedied or mitigated which the licensee will work towards implementing. But a remedy may take many other forms. It may simply require communication with licensees and the Commission can do that through its website or a “Dear CEO” letter. More formal guidance might be appropriate, typically to explain what compliance with the rules requires. Or the rules themselves may need to be changed in which case, except in serious cases clearly requiring urgent action, there will be consultation on proposed changes. Where more serious cases of rule breaches have occurred the Commission may use intervention powers to require a licensee to cease trading.

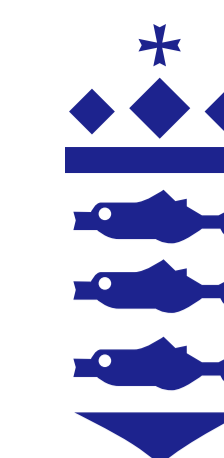
In certain cases where it is believed justified, i.e. to administer justice and create a level playing field for the law abiding or to protect investors and consumers, enforcement powers become exercisable by the Commission. The Commission may also refer cases for criminal investigation. In relation to enforcement matters, Case Review Panels are used to analyse and make recommendations based on the evidence provided.

4.6 Post-implementation review

The last limb of our regulatory decision making is to review retrospectively how we have performed. There is statutory provision for annual reporting to the States of Deliberation but this is necessarily at a high level. At a more granular level, the Board considers the broad thrust of regulatory decision making at least once a year. The executive review individual judgements both as part of supervisory and enforcement case review panels and in the performance appraisal and development planning of individual supervisors.

At individual licensee level, PRISM ensures that there is a cyclical review of how decisions have affected the conduct of individual licensees. Licensees may also express their own views in dialogue with their supervisor where necessary.

The Commission will also periodically turn to external facilitation to review its operations. This may take various forms. The governance of decision making will be covered in a board effectiveness review. A regulatory expert may be asked to review our performance to benchmark it against international standards and peers. A programme of externally commissioned internal audits allows the Board to receive external judgements on aspects of the Commission's performance.



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Conclusion

We hope that this explanation of how and why we regulate along with how we think about complex regulatory issues is helpful to residents of Colonia, our regulated entities and other interested stakeholders. We remain committed to clear communication in order to explain how we approach our duties.



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finance sector in Colonia St John.