Financial Regulation Strategy
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

14 April 2011

By e-mail to: financial.reform@hmtreasury.gsi.gov.uk

Dear Sirs

**A new approach to financial regulation: building a stronger system (February 2011 Consultation)**

We write with the response of Hampden Agencies (HAL) to HM Treasury's consultation paper issued in February 2011 headed "A new approach to financial regulation: building a stronger system".

We should like to take this opportunity to thank David Sly for making himself available for a meeting with HAL on 12 April 2011, which we found extremely helpful in gaining a better understanding of the proposals in so far as they affect Lloyd's and, in particular, HAL.

Our responses to questions relevant to HAL and the Members of Lloyd's we represent are annexed to this letter, where appropriate, in response form format.

**Background**

HAL supports the Government in its core objective "to ensure that financial firms are never again to take on risks that are so significant and so poorly understood, resulting in severe economic consequences for businesses, households and individuals".

However, HAL considers that the insurance industry in general and Lloyd's in particular is very different from the banking industry due to a number of factors:

1. Low leverage;
2. Emphasis on underwriting;
3. Strong relationship between underwriting and risk bearing;
4. Conservative investment philosophy;
5. Loss reserves cannot be withdrawn at will unlike bank deposits;
6. Economic recession has less impact on insurers' results than banks' results;



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7. Insurance industry is comprehensively regulated;
8. Greater transparency of insurance industry.

In a report we issued to our clients in April 2009 we analysed these factors in detail and enclose an extract from this report at the Appendix. Against this background, we consider that the implementation of the changes to financial regulation should be structured in such a way as to minimise the impact on Lloyd's and the Members we represent. This is important:

- To maintain the competitiveness of Lloyd's which operates in a global industry and
- Given the onset of new European "Solvency II" requirements by 1 January 2013, it is critical, in our view, that the transfer of responsibilities for Lloyd's from the FSA to the PRA operates in a seamless manner.

We welcome the recognition in your consultation that: "effective supervision of insurance firms for soundness and stability by the PRA may be achievable through a less intensive supervisory approach than would need to be the case for a bank".

However, we are concerned that it is proposed that Members' Agents will be regulated solely by the FCA. We appreciate the consumer protection agenda of the FCA which aims to address shortcomings in the FSA's approach and powers according to Hector Sants in his 2 March 2011 speech having "proved inadequate to meet the expectations of society with regard to protecting consumers in financial matters". However, Membership of Lloyd's does not follow a retail investment model; it is a trading venture whose Members are not consumers but underwriters accepting insurance risk. Therefore, we consider that the PRA is a better fit for regulating Members' Agents, of which there are only three.

**Executive Summary**

As we discussed at our meeting with David Sly Lloyd's is uniquely structured and therefore it is not an easy process to fit Lloyd's, Managing Agents and Members' Agents into the revised regulatory architecture.

We support the proposals for both Lloyd's and Managing Agents to have as their lead regulator the PRA. However, we remain of the view that Members' Agents including HAL should have as their lead regulator the PRA rather than the FCA.

We therefore request that in finalising the legislation that Lloyd's is treated on a unitary basis in so far as the lead regulator, the PRA is concerned. We understand that this position is supported by Lloyd's and will in our view:

- Minimise cost and avoid duplication of resource between the PRA and FCA;
- Ensure continuity of expertise in relation to the regulation of underwriting business at Lloyd's and
- Ensure "efficiency and proportionality", the principals of the new regulatory system.

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For the vast majority of firms the main day-to-day contact with the FCA will be through a contact centre; we find it difficult to see how this will work in practice for Members' Agents in view of the specialist and unique nature of Membership of Lloyd's.

**Memorandum of Understanding – Division of Responsibilities between FCA and PRA**

We understand that there will be a requirement for a memorandum of understanding in so far as responsibilities are allocated between the PRA and the FCA in relation to Lloyd's, Managing Agents and Members' Agents. We hope there will be consultation on this memorandum of understanding and request that we are notified of any consultation.

While we appreciate that conduct of business matters, anti-money laundering and oversight of the Lloyd's capacity auctions/major syndicate transactions/conflicts of interest lies with the FCA, which will be suitably resourced in all these areas, the expertise in relation to Lloyd's currently rests with the Lloyd's team in the wholesale insurance department of the FSA. Our understanding is that it is intended the Lloyd's team will transfer to the PRA and therefore we consider it logical and proportionate for Members' Agents "advising on syndicate participations" to be PRA regulated rather than FCA regulated which would require duplication of personnel and expertise in relation to only three Members' Agents in comparison with the 20,000 retail firms in the UK. This enables the continuity of one team of regulatory staff with Lloyd's experience which interfaces with both the Corporation of Lloyd's and regulated firms.

**Co-operation Arrangements between the PRA & FCA with the Society of Lloyd's**

While not specifically mentioned in the consultation the current co-operation arrangements between the FSA and Lloyd's entered into in August 2007 in relation to minimising the duplication of regulation of insurance business at Lloyd's will need to be revisited in the light of the new regulatory structures. We hope there will be consultation on new co-operation arrangements and request that we are notified of any consultation.

**The Case for Members' Agents to be Regulated by the PRA not the FCA**

We should like you to take account of the following facts in determining whether Members' Agents should be regulated by the FCA, the consumer and markets body, or the PRA, which will regulate insurance companies including Lloyd's.

- The European Solvency II legislation regulates what is called "the association of underwriters known as Lloyd's". The underwriters we represent being Members of Lloyd's are not retail consumers, the focus of FCA regulation, but carry on a business in their own names as an authorised insurer with several liability; this they can only do through a Managing Agent at Lloyd's. Therefore, Members of Lloyd's are in no sense consumers but rather the consumers are the insurance and reinsurance policy holders.

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- Members of Lloyd's advised by Members' Agents have a direct contractual and agency relationship with the Managing Agents for the syndicates of which they are a member and separately with the Members' Agent. This applies to the £2.6bn of underwriting capacity provided by individual Members trading either with unlimited liability or with limited liability through Limited Liability Partnerships or companies.
- A Members' Agent's sole function is to act as agent to underwriting Members and the principle exercise of that function is to advise on membership of Lloyd's syndicates. All syndicates are subject to approval of their Syndicate Business Plans by the Lloyd's Franchise Performance Board while the Managing Agents who submit those business plans have to be approved by both Lloyd's and the FSA in order to conduct underwriting business at Lloyd's. It seems to us clear that if Managing Agents are to be regulated by the PRA then Members' Agents should likewise be regulated by the PRA.
- Strictly, Members of Lloyd's are not investors as suggested in paragraph 3.28 of the consultation document but are conducting a trade and do not fit naturally into a retail financial services model.
- In so far as individual Lloyd's Members are considered to be "consumers of advice" on the conduct of their trade at Lloyd's it is our view that the consumer protection agenda of the FCA, other than in the oversight of the Lloyd's capacity auctions, major syndicates transactions byelaw and conflicts of interest is unnecessary given the high standard of protection afforded by the contractual agency agreements between Members and their Members' Agent and Members and their Managing Agent. The principal / agent relationship puts Members of Lloyd's in a very different position to retail consumers. HAL has a very transparent complaints procedure but ultimately Members of Lloyd's have rights of legal action against both Managing and Members' Agents as well as access to the Lloyd's Arbitration Scheme.

**The Financial Services Compensation Scheme**

In the July 2010 consultation document the Government asked for views on the alternative funding mechanisms for the FSCS. We favour the ending of the current cross subsidy between different classes of levy payers. However, the current February 2011 consultation appears to be silent on this topic. The method of allocation we would favour is for levies to be made based on the permissions given to the authorised firm.

We are aware of the proposals for a new EU directive in this area and consider it important that cross subsidy is ruled out now in the UK by our new legislation as a matter of principle as a method of allocating levies. We have a particular concern should Members' Agents be FCA lead regulated that we would be allocated to a category of retail financial service providers which we think would be inequitable given the protections afforded to Members of Lloyd's under the agency agreements byelaw and the existence of the Lloyd's Arbitration Scheme. Currently, we understand from the FSA that based on HAL's current permissions we are exempt from any levy by the FSCS.

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In relation to the funding of the FSCS post the establishment of the PRA and FCA we ask that there be consultation at that time on the allocation of levies and trust that we will be included in such a consultation.

We hope that you find our submission helpful and would be more than happy to make ourselves available for a further meeting should you wish.

If there are any questions about our submission or any other matter in so far that it affects Members' Agents at Lloyd's please do not hesitate to contact the undersigned.

With kind regards.

Yours faithfully

John E H Francis

**E**: john.francis@hampden.co.uk
**T**: +44 (0) 20 7863 6548

cc David Sly



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**ANNEX**

| | |
|---|---|
| **Name** | John Francis |
| **Position** | Director, Hampden Capital Plc<br>Research Director, Hampden Agencies Limited |
| **Company** | Hampden Agencies Limited |
| | Hampden Agencies is the largest Members' Agent at Lloyd's acting for 377 unlimited liability Members and 816 limited liability Members for the 2011 underwriting year of account. The individual Members we advise have aggregate underwriting capacity of £1.36bn for 2011 or 5.8% of Lloyd's £23.2bn capacity. In total individual Members provide underwriting capacity of £2.6bn, which gives Hampden Agencies a 52% market share among three Members' Agents. |
| **Address** | 85 Gracechurch Street, London |
| **Post Code** | EC3V 0AA |
| **Telephone** | 0207 863 6548 |
| **Email** | john.francis@hampden.co.uk |
| | |
| **In what capacity are you responding?** | |
| On behalf of Hampden Agencies Limited | |

**HAMPDEN ANSWERS TO CONSULTATION QUESTIONS**

| | |
|---|---|
| **1.** | **What are your views on the likely effectiveness and impact of these instruments as macro-prudential tools?** |
| | |
| **2** | **Are there any other potential macro-prudential tools which you believe the interim FPC and the Government should consider?** |
| | |
| **3.** | **Do you have any general comments on the proposed role, governance and accountability mechanisms of the FPC?** |



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| | |
| | |
| **4.** | **Do you have any comments on the proposals for the regulation of systemically important infrastructure?** |
| | |
| **5.** | **What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the PRA?** |
| | The Memorandum of Understanding between the PRA and FCA will be important in avoiding duplication and mitigating the additional cost burdens. The focus on financial stability of the PRA is closely aligned with the Members of Lloyd's whom HAL represents as their return on capital is dependent on the performance of the Managing Agents in their role managing syndicates. This is another reason why we believe it is sensible for Members' Agents to be likewise lead regulated by the PRA. |
| **6.** | **What are your views on the scope proposed for the PRA, including Lloyd's, and the allocation mechanism and procedural safeguards for firms conducting the 'dealing in investments as principal' regulated activity?** |
| | In our covering letter we have detailed the rationale for our request that the PRA's scope be extended to include being the lead regulator for Members' Agents as well as Managing Agents and Lloyd's. |
| **7.** | **What are your views on the mechanisms proposed to make the regulator judgement-led, particularly regarding: rule-making; authorisation; approved persons; and enforcement (including hearing appeals against some decisions on a more limited grounds for appeal)?** |
| | |
| **8.** | **What are your views on the proposed governance framework for the PRA and its relationship with the Bank of England?** |
| | |
| **9.** | **What are your views on the accountability mechanisms proposed for the PRA?** |
| | |
| **10.** | **What are your views on the Government's proposed mechanisms for the PRA's engagement with industry and the wider public?** |
| | |
| **11.** | **What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the FCA?** |
| | The operational objectives of the FCA are sensible in: |



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<table>
<tr><td></td><td>a) facilitating efficiency and choice in the market for financial services;<br>b) securing an appropriate degree of protection for consumers; and<br>c) protecting and enhancing the integrity of the UK financial system<br>However, they are not an easy fit with the business of Members' Agents and underwriting Members of Lloyd's. There are currently only 30 syndicates available to individual Members of Lloyd's out of a total of 85 and it is difficult to see how the FCA can provide more choice. The protection of Members is paramount within the Lloyd's regulatory structure through the Agency Agreements, the statutory duties of Lloyd's and the Lloyd's Arbitration Scheme. The integrity of the UK financial system in relation to Lloyd's is protected by the PRA's ICAS capital setting regime and the risk/performance management framework of Lloyd's.<br><br>However, there are three areas where the FCA would be relevant in its supervisory role of Lloyd's where third party individual Members of Lloyd's require continuing consumer type protection and which have the potential for disproportionate reputational and adverse financial damage for the Members we represent if one or more were to go awry. These three areas are:<br>1) The annual Capacity Auction process for the purchase and sale of syndicates;<br>2) The Major Syndicate Transactions byelaw in particular the Minority Buy Out process for aligned capital to acquire on a compulsory basis the non-aligned capacity owned by the Members we represent; and<br>3) The conflicts of interest where aligned capital sits alongside unaligned capital.</td></tr>
<tr><td>12.</td><td>What are your views on the Government's proposed arrangements for governance and accountability of the FCA?</td></tr>
<tr><td></td><td></td></tr>
<tr><td>13.</td><td>What are your views on the proposed new FCA product intervention power?</td></tr>
<tr><td></td><td></td></tr>
<tr><td>14.</td><td>Government would welcome specific comments on:<br>• the proposed approach to the FCA using transparency and disclosure as a regulatory tool;<br>• the proposed new power in relation to financial promotions; and<br>• the proposed new power in relation to warning notices.</td></tr>
<tr><td></td><td></td></tr>
<tr><td>15.</td><td>Which, if any, of the additional new powers in relation to general competition law outlined above would be appropriate for the FCA? Are there any other powers the Government should consider?</td></tr>
<tr><td></td><td></td></tr>
<tr><td>16.</td><td>The Government would welcomes specific comments on:</td></tr>
</table>

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| | • **the proposals for RIEs and Part XVIII of FSMA; and**<br>• **the proposals in relation to listing and primary market regulation.** |
| | |
| **17.** | **What are your views on the mechanisms and processes proposed to support effective coordination between the PRA and the FCA?** |
| | The Memorandum of Understanding between the PRA and FCA will be important in avoiding duplication and mitigating the additional cost burdens. We hope there will be consultation on this memorandum of understanding and request that we are notified of any consultation. |
| **18** | **What are your views on the Government's proposal that the PRA should be able to veto an FCA taking actions that would be likely to lead to the disorderly failure of a firm or wider financial instability?** |
| | |
| **19** | **What are your views on the proposed models for the authorisation process – which do you prefer, and why?** |
| | It is important to avoid cost and duplication of two authorisation procedures. HAL therefore favours the alternative approach such that the lead authority is responsible for processing the application seeking consent from the other where appropriate. |
| **20.** | **What are your views on the proposals on variation and removal of permissions?** |
| | |
| **21.** | **What are your views on the Government's proposals for the approved person's regime under the new regulatory architecture?** |
| | |
| **22.** | **What are your views on the Government's proposals on passporting?** |
| | |
| **23.** | **What are your views on the Government's proposals on the treatment of mutual organisations in the new regulatory architecture?** |
| | |
| **24.** | **What are your views on the process and powers proposed for making and waiving rules?** |
| | |
| **25.** | **Government would welcome specific comments on**<br>• **proposals to support effective group supervision by the new authorities – including the** |

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| | **new power of direction; and**<br>• **proposals to introduce a new power of direction over unregulated parent entities in certain circumstances?** |
| | |
| **26.** | **What are your views on proposals for the new authorities' powers and coordination requirements attached to change of control applications and Part VII transfers?** |
| | |
| **27.** | **What are your views on the Government's proposals for the new regulatory authorities' powers and roles in insolvency proceedings?** |
| | |
| **28.** | **What are your views on the Government's proposals for the new authorities' powers in respect of fees and levies?** |
| | Allocation of fees should be transparent as to cost apportionment and subject to consultation. |
| **29.** | **What are your views on the proposed operating model, coordination arrangements and governance for the FSCS?** |
| | In relation to levies HAL's permissions are currently exempt from the FSCS and we would expect that to remain the case. We comment in more detail on the FSCS in our covering letter. The method of allocation we would favour is for levies to be made based on the permissions given to the authorised firm. We are aware of the proposals for a new EU directive in this area and consider it important that cross subsidy is ruled out now in the UK by our new legislation as a matter of principle as a method of allocating levies |
| **30.** | **What are your views on the proposals relating to the FOS, particularly in relation to transparency?** |
| | |
| **31.** | **What are your views on the proposed arrangements for strengthened accountability for the FSCS, FOS and CFEB?** |
| | |
| **32.** | **What are your views on the proposed arrangements for international coordination outlined above?** |
| | We welcome the fact that the PRA will have a representative on EIOPA as it is important that UK insurers are properly represented in Europe in view of the impact of legislation on UK insurers including Lloyd's. |

APPENDIX.



# NON-LIFE INSURANCE INDUSTRY IS VERY DIFFERENT FROM THE BANKING INDUSTRY

Insurance markets, unlike banking, are operating normally. The basic function of insurance continues uninterrupted – the ordinary transfer of risk from client to insurer or insurer to reinsurer. Operationally, insurance companies are functioning in a very different way from banks. They continue to:

- Pay claims (whereas 41 US banks have gone under as of 28 February 2009);
- Renew existing policies (whereas banks are reducing and eliminating lines of credit);
- Underwrite new policies (whereas banks are turning away clients who want or need to borrow); and
- Develop new products (whereas banks are scaling back the products they offer).

*Source: Insurance Information Institute*

*Insurers are likely to be less affected by the recession than banks*

With insurers operating normally it should not be surprising that the investment proposition for investing in insurance as compared with banks is very different.

With some limited exceptions, property casualty insurers have fewer problems than banks and are likely to be less affected by the economic recession. In fact, the insurance industry may benefit from the "credit crunch" as the availability of risk bearing capital reduces. Many investors are seeking to avoid risk while the availability of credit from banks has reduced due to heightened focus on asset quality and pressure on tier one capital ratios from asset write-downs.

A number of key differences have been identified by the Insurance Information Institute, which we discuss below. These are:

1. Low Leverage;
2. Emphasis on Underwriting;
3. Strong Relationship between Underwriting and Risk Bearing;
4. Conservative Investment Philosophy;
5. Loss Reserves cannot be Withdrawn at will unlike Bank Deposits;a
6. Economic Recession has less Impact on Insurers' Results than Banks' Results;
7. Insurance Industry is Comprehensively Regulated; and
8. Greater Transparency of Insurance Industry.

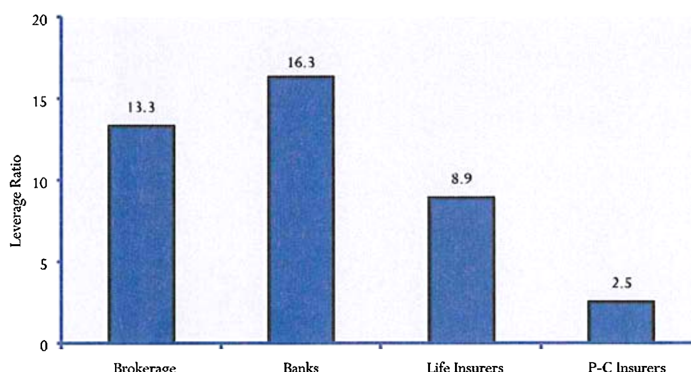
## 1. Low Leverage

*Insurers' leverage is much lower than banks*

The operating model of property/casualty insurers is very conservative compared with other financial services businesses using the average leverage ratio as a measure of conservatism. The low level of leverage of insurers explains why, during the current financial crisis from 2008 through to February 2009, 41 US banks have failed but not one property casualty insurance company has failed *(source: Insurance Information Institute).*

A recent report from Credit Suisse highlighted that the average leverage ratio for banks was 16.3 (tangible assets divided by tangible equity) at the end of the third quarter of 2008, compared with only 2.5 for property casualty insurers (invested assets divided by equity). This gives an asset loss cushion of only 6% for banks, compared with 40% for insurance companies.

### *Leverage Levels by Type of Financial Institution (Q3 2008)*




*Source: Credit Suisse, Financial Services 2009 (Sector Review):*
*"De-leveraging, De-risking, Consolidation & Regulation. Expect More of All," 19 Dec. 2008, p. 3*

The US insurance analyst, Dowling and Partners, says that over the last decade the property/casualty insurance sector is the only sector of financial services where leverage has declined. In contrast, one of the factors behind the current financial crisis was a decision by the SEC in 2004 to permit investment banks' brokerage units to take on more leverage. Alan Blinder, professor of economics at Princeton, says "before then, leverage of 12 to 1 was typical; afterward it shot up to more like 33 to 1. Had leverage stayed at 12 to 1, these firms would not have grown so big or been as fragile".

**2. Emphasis on Underwriting**

Using loss experience and exposure modelling, underwriters seek to match risk to price with the aim of securing an underwriting profit, once business underwritten is no longer on risk. In recent years insurers have become more sophisticated in their price and exposure modelling. Lloyd's introduced Underwriting Management Standards in July 2006, which were further refined in October 2008, including a requirement for pricing models and rate monitoring tools.

**3. Strong Relationship between Underwriting and Risk Bearing**

Lloyd's introduced strict controls on "arbitrage" in 2003, by requiring as one of the Franchise Performance Board guidelines that there must be a minimum 10% retention ratio for each risk underwritten. In contrast, one of the factors behind the banking crisis is that some banks sought to maximise volume and fees and disregarded risk by securitising assets that were sold on to outside investors. The consequence of this was the straightforward moral hazard problem.

**4. Conservative Investment Philosophy**

*Insurers are generally not forced sellers of assets*

Non-life insurers typically have a more conservative investment philosophy, focussed on bonds, although some companies have material exposure to mortgage backed securities due to the incremental yield these bonds offered. However, unlike banks, insurance companies are not generally forced sellers of their investments since they seek to match their assets to their liabilities. Lloyd's is currently in a better position, in our view, than its competitors since the three-year underwriting account requires investments to be of shorter duration and more liquid.

**5. Loss Reserves cannot be Withdrawn at will unlike Bank Deposits**

*Insurers cannot be subject to a 'run on the bank'*

The banking system depends on confidence of depositors who usually have the right to withdraw deposits with no notice. This was the proximate cause for the government sponsored rescue of Bear Stearns by J P Morgan and the

nationalisation of Northern Rock. In contrast, the largest liability of insurance companies is their loss reserves which cannot be withdrawn at will by policyholders but requires valid claims.

**6. Economic Recession has less Impact on Insurers' Results than Banks' Results**

Economic recession has a direct impact on banks' assets due to write-offs from non-performing loans. In contrast, the impact on insurers from recession is less marked. While demand for insurance does reduce in a recession, particularly for businesses rated on turnover, for most business insurance is not a discretionary purchase but an economic necessity. Claims activity can rise in a recession, which can affect particularly some of the liability classes, as litigation tends to rise. However, underwriters have the opportunity to take account of projected increases in claims activity by increasing rates, which we expect to be one of the factors in the hardening market of 2009 and 2010.

**7. Insurance Industry is Comprehensively Regulated**

The business of insurance remains comprehensively regulated in contrast with the banking system where "shadow banks" have evolved largely outside the auspices of regulators, such as hedge funds and private equity. In contrast, consumer protection is at the forefront of the regulation of insurance with US state legislature being responsible for setting policy since 1945 with industry oversight being coordinated by the National Association of Insurance Commissioners. In the UK, Lloyd's is regulated by the FSA with individual syndicates being subject to additional scrutiny through the requirement to have their business plans approved on an ongoing basis by the Franchise Performance Board. In Europe, the industry is currently preparing for improved solvency standards, known as Solvency II which are intended to offer reduced capital requirements for better risk management systems. Solvency II is expected to be introduced in 2012.

**8. Greater Transparency of Insurance Industry**

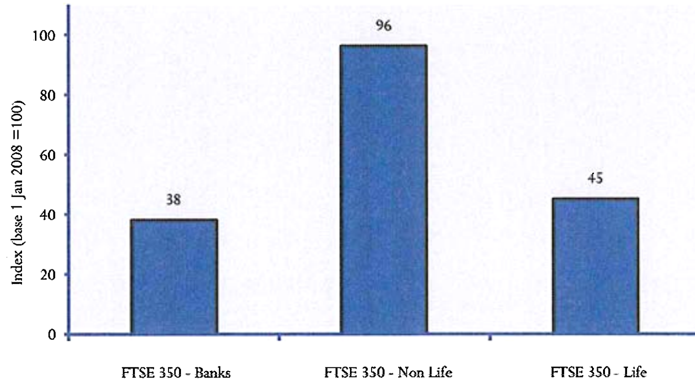
Loss triangulations for insurance companies by class of business are available for scrutiny in the US through Schedule P reports and the UK through FSA returns. This transparency enables in particular comparative reserving strength to be analysed by investors and rating agencies since under-reserving has been one of the main causes of insurance company failure. In contrast, off balance sheet Structured Investment Vehicles have been less than transparent and proved to be one of the factors behind the problems of banks such as Citigroup and HBOS. In Europe updated accounting requirements are also expected by 2012 (IFRS Phase II) with an objective of improving the understanding of reported figures to users of accounts.

*The stock market has distinguished non-life insurers from life assurers & banks.*

Over the past year the stock market has begun to distinguish between banks and non-life insurance companies, although certain companies such as AIG, Swiss Re and XL Capital have been severely impacted by investments in mortgage backed securities and the underwriting of financial guarantee products such as being a protection seller of Credit Default Swaps.

The chart below shows the percentage change between 1 January 2008 and 15 April 2009 of three FTSE financials indices being the banks, life and non-life. It can be seen that in one of the worst "bear" markets the non-life index has been relatively unscathed falling only by 4% compared with 55% for the life assurers and 62% for the banks.

### FTSE 350 Financial Indices




*Source: FTSE 350 Data 1 January 2008 to 15 April 2009*

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13 April 2011

Dear Sir

**A new approach to financial regulation: building a stronger system**

Thank you for the opportunity to comment on the proposals relating to the new approach to financial regulation.

Hargreaves Lansdown is a leading provider of investment management products and services to retail investors in the UK. Our flagship service, Vantage, is a direct-to-retail client fund supermarket and wrap platform. Vantage offers clients the administrative convenience of being able to hold and manage their investments, including unit trusts, OEICs, equities, bonds, investment trusts and cash, in one place with consolidated valuation reports, a single dealing service and instant online access. Hargreaves Lansdown has over 346,000 Vantage clients administering £20.9 billion of assets directly on their behalf.[1]

In addition to offering externally managed investment products, Hargreaves Lansdown manages £2.1 billion of funds through its own range of multi-manager unit trusts and its discretionary portfolio management service. We also provide independent financial advisory and stockbroking services to retail clients and advisory services to companies in respect of group pension schemes.

Our detailed comments in response to the consultation relate to the proposed approach of using transparency and disclosure as a regulatory tool, in particular the proposed new powers in relation to financial promotions, warning notices and FOS decisions. We are concerned that using transparency and disclosure as a regulatory tool will not deliver the benefits the Government expects in enhancing client confidence in the new system and enabling clients to make informed decisions and will in practice have unintended and negative consequences.

**New power in relation to the early publication of warning notices.**

We disagree with this proposal. It will result in firms being pre-emptively penalised by the regulators, an increase in easy to report ‘bad news’ headlines, and clients taking ill- informed decisions to leave firms/products in situations where this is unwarranted. We are concerned that what is in essence a radical approach, will have unintended consequences and that the safeguards in relation to the proposed new power will not go far enough in protecting the clients, firms and individuals affected. To ensure a greater understanding we would welcome some examples of the type of scenario where this power could effectively be used.

We believe there are certain implications of publishing warning notices which could have a detrimental impact on the firm/individual and the clients affected and could serve to undermine the

[1] As at 31 December 2010 (figures taken from the HL Group Plc unaudited interim results Feb 2011)

Government's objectives in enhancing client confidence in the new system and enabling clients to make informed decisions:-

- Clients may draw ill-informed conclusions leading them to unnecessarily withdraw from products where it may not be in their best interests to do so. There is a danger that this will produce poor client outcomes and could also complicate the situation for firms where they are required to take action to resolve a failing;
- Media attention will focus on the 'bad news' headlines rather than the context of the situation because full details of the enforcement action will not be known at this stage;
- Firms/individuals could effectively be placed in a 'no win' position where they will want to, but may be unable to satisfactorily respond to questions from clients or the media;
- Lasting damage will be caused to the reputation of a firm/individual regardless of any subsequent 'notice of discontinuance'.

If it is intended that these are the kind of implications that would be assessed under the proposed procedural safeguard of having to consider the impact of the disclosure on the affected firm/individual and the FCA/PRA's regulatory objectives, we are not sure when in fact it would be appropriate for the FCA/PRA to use the power. The Government may wish to consider providing further guidance in relation to the procedural safeguards as to when it would be considered appropriate/inappropriate to use the power.

The Government believes that greater transparency regarding enforcement action that is underway would increase visibility, enhance consumer confidence in the new system and enable consumers to make more informed decisions. The Government also points to this as being a way of telling firms what behaviours are considered to be unacceptable. We believe the tools to achieve these objectives already exist. A large part of the FSA's website is client orientated and includes information on issues relating to products and practices that clients should be aware of, for example PPI sales, Unregulated Collective Investment Schemes and Structured Products (post Lehmans). The FSA also provides firms with information through various mechanisms (thematic work, good and poor practices and 'Dear CEO letters)' all of which give advance warning of the behaviour the regulator considers unacceptable. Final notices from enforcement action are also published (and accessible by the public) which enable firms to benchmark themselves against other's failings. The extent to which the FSA has been effective in using the tools at its disposal is a different question from whether or not the introduction of a new discretionary power to publish early notification of enforcement action is in fact necessary. Given that other aspects of regulatory reform such as proactive intervention, issues-based supervision and risk analysis will also work towards achieving the objectives of credible deterrence and enhancing consumer confidence, we question that the power of early publication of enforcement action is needed as a regulatory tool.

We would be interested to learn more about the transparency 'gaps' that would be filled by this new power and if there are any plans to conduct research into client behaviour and what the likely reaction to publications of this type would be. For example, how likely is it that a client will take action after a warning notice is published – this will be dangerous when the action taken is not as a result of being in a fully informed position.

As the emphasis shifts towards more proactive, intensive and intrusive regulation there is the likelihood of increased enforcement action for firms. This makes it even more important for there to be a clear understanding amongst regulated firms and clients as to the benefits underlying the power to publish a warning notice and that there are clear and comprehensive safeguards in place to ensure 'procedural fairness'.

**New power in relation to financial promotions**

We disagree with the proposal to publish details where a firm has been directed to amend or withdraw a financial promotion. The FCA should continue with the FSA's practice where if a financial promotion does not meet the required standards, the firm is directed to amend/withdraw where necessary and if there is a likelihood of client detriment the firm will also be directed to undertake remedial action as appropriate. This approach does not produce poor outcomes for clients.

We do not see any benefit in publishing instances where a firm has been asked to amend/withdraw a financial promotion.  The FCA should determine the significance of the financial promotion failing and the likelihood of client detriment, not the ‘ambulance chasers’ who will be galvanised into action by this transparency.

**Proposal relating to the FOS and the provision to publish decisions.**

We understand that the FOS will have the provision to publish decisions if it considers it appropriate to do so and will be expected to consult on the principles it intends to apply.  We believe there are important considerations for the FOS to address in its consultation, as this proposal is at odds with the way in which the FOS currently operates.

Most notably we are concerned that the publication of case decisions will increase the risk that ‘ambulance chasers’ will ‘jump on the band wagon’, target firms and products and create mass claims. The FOS has previously warned clients about using these types of firms, questioned the quality and expertise of their claims management and the fact that clients use them when regulated firms and the FOS have complaints handling mechanisms that are accessible without the need to pay for the services of a third party firm.  This provision would essentially ‘open the flood gates’ for third party claims management firms.

It is well known that the FOS deals with each case on its merits and is not bound by the precedent of its previous case rulings.  This means that similar complaints may have different decisions attached to them.  This practice will become more and more apparent as decisions are published.  How then will the FOS plan to deal with consistency issues, as on the face of it this provision seems to conflict with the way in which the FOS works.

There is considerable unease within the financial services industry regarding the lack of an effective appeals process to any FOS decision. Regulated firms often face situations where they receive a judgement from the FOS that they regard as unreasonable, unjustified or unfair. However, the lack of an appeal process means the firm just needs to accept this. We believe it would be unfair of the FOS to seek to publish decisions where there is no appeal process for the firm.

We have assumed that the FOS will be balanced in its approach and publish decisions that are found for and against firms and complainants alike.  The FOS should consider that clients may be reluctant to complain if they know that decisions will be published when not found in their favour. We would also expect the FOS to consider personal data security when it consults on the use of this provision and even then to consider whether it should only publish a decision when the complainant and the firm (in the absence of an appeals process) consent to the publication.  Given these considerations it may transpire that only limited information about the decision will in practice be able to be published, which may not be too far removed from the information that the FOS already publishes on its website via case studies (the only difference being that under the new provision a firm will be directly linked to the publication.)

I hope this letter provides helpful and relevant points for your consideration. Please contact us if you would like to discuss anything in further detail.

Kind regards

Helen Price
Senior Compliance Manager

# Herbert Smith

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Date
14 April 2011

Dear Sirs

**HM Treasury Consultation Paper 'A new approach to financial regulation: building a stronger system'**

This is Herbert Smith LLP's response to HM Treasury's Consultation Paper **'A new approach to financial regulation: building a stronger system'** ("the Consultation"). As a leading international law firm, Herbert Smith advises a wide range of financial institutions, including retail and investment banks, insurers, building societies and investment firms, and has been involved with the work of several leading trade associations in this context. We are pleased to have the opportunity to comment on the Consultation Paper.

1. **What are your views on the likely effectiveness and impact of the macro-prudential tool instruments?**
2. **Are there any other potential macro-prudential tools which you believe the interim FPC and the Government should consider?**

*Generally*

Whilst the likely effectiveness and impact of the macro-prudential tool instruments falls outside our area of direct expertise, we would make the overall comment that the empirical evidence of the potential effects and impacts of the use of these tools in isolation, and the likely interaction of the effects of the use of different tools simultaneously, is still nascent, and the majority of the tools remain untested. This is acknowledged through the conditional language used in the Consultation, and expressly so at paragraph 2.48, which endorses the need for careful consideration to determine likely impact and effectiveness, and also their potential costs. Clearly a two month consultation period would never have been sufficient for this purpose; the responses elicited by the Consultation are an important first step to facilitate what we hope will be an ongoing process of consultation and consideration of these issues, and which will engage with the industry on the issue of potential costs as well as of impacts and effectiveness.

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*Consultation*

For that reason we believe that it will be vital that the FPC should be required to consult on, and publish, a policy statement in advance about how it would generally expect to use each tool, in what circumstances, and the rationale for their use.

We also believe that, save only where the delay thereby incurred would pose a risk to financial stability, the PCA and the FCA should be required to consult, and prepare an impact analysis, on how they intend to implement a direction by the FPC to implement a macro-prudential tool.

*The collateral requirements tool – haircuts on repurchase agreements and OTC derivatives*

Many of the tools form part of the Basel III package of reforms and have been fully endorsed by the G20. We note, however, in respect of the proposed collateral requirements tool, that in its report (cited at footnote 6 of the Consultation), the Committee on Global Financial Systems ("CGFS") considered it was far from clear how, and indeed whether, policy makers should be influenced by the very limited indirect empirical support provided by the available academic studies, given the highly simplified and stylised nature of the models explored. The CGFS specifically warned that the effects may be less clear in the presence of other credit terms that may be simultaneously adjusting.

Accordingly, the CGFS's recommendation was that further consideration should be given to the prudential impacts and practical implications of imposing the tool in question in respect of secured lending or derivatives transactions. It seems therefore, in our view, somewhat premature to advocate inclusion of this particular tool in the FPC toolkit.

In addition, it is not clear whether or how this tool might affect obligations owed under pre-existing contracts. Firms should not be placed in a position where they are forced to choose between non-compliance with a regulatory requirement and breach of pre-existing contractual obligations. We also note that the counterparties to such contracts will not necessarily be entities that are subject to PRA or FCA regulation.

*Ad-hoc tools*

Finally, we can envisage that in rare and exceptional circumstances, there could be a need to create ad-hoc tools at short notice, particularly where there was otherwise no legal power to carry out the action proposed. We believe that the power to create such tools should be carefully circumscribed. The requirement to obtain Parliamentary approval would be one appropriate safeguard, although it is not clear from the Consultation what would then happen if such approval were not forthcoming; we assume that the tool would be withdrawn from the toolkit, and the intervention promptly reversed.

We are however concerned by the suggestion that the FPC might seek the creation of such a tool in circumstances where the PRA or the FCA was refusing to comply with a recommendation on the grounds that it believed that the action would have significant unintended consequences. The FPC should at a minimum be required to take full account of the potential unintended consequences outlined by the authority in coming to its decision to request the Treasury to amend the FPC's toolkit. The Consultation suggests, and we agree, that the legislation should require that the Treasury then determine whether, in its view, the authority's reasons for not complying are sufficient, or whether it is appropriate to create the tool in question.

**3. Do you have any general comments on the proposed role, governance and accountability mechanisms of the FPC?**

*Functions*

*The FPC's objective and 'have regards'*

We support the proposal that the FPC's responsibility in relation to the achievement of the Bank's Financial Stability Objective should relate primarily to the identification of, monitoring of, and taking of action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The formulation is wide enough to ensure that the FPC will be required to identify and monitor systemic risks developing beyond the UK with a view to protecting and enhancing the resilience of the UK financial system.

We agree that the FPC should be responsible for protecting the resilience of the financial system generally, rather than for delivering any particular level of leverage, debt or credit growth, and that it should not exercise its functions in a fashion which would have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy.

We welcome the inclusion of the specific factors to which the FPC should have regard. We also note that it is important that, in recommending or directing action to be taken by other bodies, the FPC should have regard not only to any international law constraints, as suggested in paragraph 2.20, but also to the potential impact of any actions that international bodies (particularly the European Supervisory Authorities) may be considering or taking, and the cumulative effect of that action, and the FPC's own proposals.

The publication of guidance on the FPC's remit and the FPC's response would be helpful in clarifying the approach the FPC will take in pursuing its objectives.

*Functions*

We agree that the FPC's powers should not be directed at, or exercised in respect of, individual regulated firms, and that the supervision and regulation of firms should remain the responsibility of the relevant authorities. We are therefore concerned by the suggestion in paragraph 2.29 that the FPC's macro-prudential interventions could in practice be aimed at one large institution – it seems to us inherently unlikely that a single institution would manifest a particular systemic risk that was not shared in some measure by other firms.

In the same vein, the broad power to make recommendations to the financial sector directly (referred to in paragraph 2.33) should clearly be limited to recommendations of an advisory nature. It is not presently clear how this general power would differ in practical effect from the making of public pronouncements and the issue of timely public warnings to raise systemic issues, facilitate market solutions or influence opinion (paragraph 2.30).

We endorse the proposal that macro-prudential tools should, so far as possible, be agreed and implemented in a way that is broadly consistent internationally. The FPC should not only be influencing macro-prudential policy in Europe and internationally, but should also, in determining

whether to use any such tool, be required to take into consideration whether, and how, this may interact with the deployment of any similar or other macro-prudential tools which European authorities may be contemplating.

The imposition of a proposed statutory requirement on the PRA and the FCA to comply, as soon as practicable, with an FPC recommendation, or to explain why it is not doing so, should take full account of the importance of the authorities undertaking consultation, impact assessment and cost benefit analysis.

The requirement that both Houses should approve the secondary legislation that establishes the toolkit of macro-prudential tools is an important safeguard, given the untested nature of a number of the tools, and should be applied in respect of every subsequent addition to the toolkit.

*Membership and governance*

The Bank has been given not only a majority of members on the FPC, but also (through the Governor, as Chair) a second casting vote – we note that the Government intends to give further consideration to comments by the TSC, which we endorse, in relation to the balance of membership within the FPC.

Separately, we would underscore the importance of having insurance expertise within the FPC. It is not clear quite how this need is reflected in the present make-up of the interim committee. As the consultation acknowledges, insurance business models are very different to those of banks, and insurance firm failure is less likely to be of systemic importance. It is therefore critical that, particularly in making recommendations or directions, the FPC be in a position to ensure that the action it proposes takes proper account of the characteristics specific to insurance firms, and the implications for policyholders and beneficiaries of the proposed action, as required by Solvency II.

*Transparency and accountability*

- *Financial Stability Reports*

  The requirement for the FPC to include an assessment of the effectiveness of its actions in its twice yearly Financial Stability Report is a critical discipline. Such reports should provide an assessment of the effectiveness of both the activities in the period since the previous report and of previous interventions. As paragraphs 2.49 and 2.50 of the Consultation acknowledge, it may be several years before the precise impact of certain interventions are fully understood, and it is vital that the FPC provides an ongoing assessment of how it believes the tools are working.

- *Meeting records*

  We support the proposal that the FPC should not be required to include in its published records any advice it gives on liquidity operations managed by the Bank. We also agree that, given the highly confidential and market sensitive nature of some of the FPC's discussions, it is essential that the FPC should have the ability to redact material in the public interest.

  In relation to meeting records, but also more generally, we note that the FPC and its members will need to be mindful of obligations under section 348 of FSMA in respect of any confidential information, including single market directive information, which may have been disclosed by the PRA or the FCA.

- *Accountability for the FPC's use of directions*

  We agree that the legislation should provide that decisions given by the FPC to the PRA or the FPC should be copied to the Treasury.

  It is not, however, clear how or by whom the public interest test referred to in paragraph 2.90 would be applied – we would expect that the Treasury and the FPC should jointly consider whether it was in the public interest that a particular direction should be laid before Parliament, rather than the FPC in isolation.

  We have already indicated that we believe it is critical that the FPC should be required to consult on, and publish, a policy statement in advance about how it expects to use each tool, in what circumstances, and the rationale for its use. Further, in the ordinary course, the PCA and the FCA should consult, and prepare an impact analysis, on proposals to implement FPC recommendations or directions. This is of particular importance given the unknown long term impacts of hitherto untested tools, and the significant potential for unintended consequences, some of which may, in themselves, prove adverse to financial stability.

  As indicated above, it would be helpful to clarify what the process would be if parliamentary approval were not forthcoming in relation to a particular ad-hoc tool.

*Interaction between macro- and micro-prudential regulators*

It is clearly important that both the PRA and the FCA work collaboratively with the FPC and the Bank. It is equally important that all the relevant bodies, including the Bank and the FPC, should strive to ensure that regulation is proportionate and to coordinate their actions in relation to firms.

The Bank is to be required to "aim to" work with other relevant bodies in pursuing its Financial Stability objective, but will not be under a duty to consult or coordinate with the PRA or the FCA (subject to paragraph 2.135, as to which see our response to question 4 below). Although we would not necessarily expect to see a statutory duty to consult or cooperate, we envisage that there will be memoranda of understanding between the Bank and the authorities setting out how the bodies will work together.

Whilst the establishment of information systems to ensure a ready exchange of information will be important, these will need to take account of restrictions on the sharing of confidential information and single market directive information.

Although the Consultation refers to the need for a collaborative two-way exchange of information, advice and expertise relevant to financial stability at paragraph 2.106, there is likewise no requirement for the FPC to consult with the PRA and FCA, although we accept that:

- both are represented on the FPC;
- the PRA and the FPC will be required to provide information to brief FPC members on any developments within their sphere of influence that may impact on financial stability; and
- both may consult the FPC on any matters that may have an impact on financial stability.

It would be regrettable if the FPC were not to entertain the possibility of drawing on the expertise available in the PRA and FCA both generally, and specifically to assist it in understanding the potential impacts, and unintended consequences, of the interventions it may be considering.

**4. Do you have any comments on the proposals for the regulation of systemically important infrastructure?**

Paragraph 2.135 refers to the Bank and the FCA adhering in general terms (presumably as between themselves) to the relevant general principles governing coordination of the PRA and FCA. We believe that the Bank's role as supervisor of settlement and payment systems and central counterparties makes it necessary for it to consult and coordinate with, in particular, the FCA as market regulator, and that, given the importance of this infrastructure to the smooth and orderly functioning of the markets, the legislation should, in due course, and subject to the final shape of the European Market Infrastructure Regulation ("EMIR"), appropriately reflect this. We assume that the Government's intention is not to goldplate European legislation.

We would be interested in commenting in due course on the detail of the proposals to enhance the Bank's ability to conduct an effective supervisory regime in respect of systemically important infrastructure. At this stage, we would simply note the following:

- the Bank should be required to consult publicly in respect of the proposed issuance or amendment of Codes of Practice for settlement systems;
- it seems appropriate that persons (operators of settlement systems, payment systems and clearing houses) acting at the direction of the Bank should be given immunity from liability for damages for action (or inaction) taken in accordance with certain kinds of direction given by the Bank;
- it is however also important that there be an ability for such persons, and for others affected by such directions, to challenge such directions by way of judicial review, and that any enforcement process in respect of the imposition of penalties is fully compliant with article 6 of the ECHR;
- clearly, in view of its remit in relation to client assets and as regulator of markets, it will be important that the FCA should have close and meaningful involvement in any decision-making concerning the resolution of a failed central clearing counterparty.

*Crisis management*

The proposals for statutory mechanisms to support close cooperation between the Treasury and the Bank group, including the MoU on crisis management, are important, and will need to address the potential for conflict of interest between the PRA in its role as prudential supervisor of regulated firms, and the Bank in the operation of the Special Resolution Regime. The Governor's role, in particular, will pose particular issues, as he will be required to manage his responsibilities for the Special Resolution Unit, and at the same time the chairmanship of the FPC and the PRA (and the MPC). The EU paper on crisis management notes that supervisors and resolution authorities are, in many jurisdictions, kept separate, in part, to reduce the incentives for regulatory forbearance.

It will also be very important to consult and coordinate with the European Supervisory Authorities, which also have considerable powers to intervene in crisis situations, on any proposed action.

**5. What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the PRA?**

We agree that, although the PRA's operational objective should be contributing to the promotion of the safety and soundness of the firms it regulates, this should include minimising the adverse effects of any failure of such firms on the UK financial system rather than seeking to eliminate firm failure.

We believe, however that there may be a need to modify the PRA's objectives, so far as the supervision of insurance firms is concerned, to take into account article 27 of Solvency II, which provides that the main objective of supervision is the protection of policyholders and beneficiaries. Because Solvency II is essentially a maximum harmonisation measure, its provisions will often constrain the PRA's regulatory responses – however in areas of discretion, Solvency II would seem to require the PRA to focus on the protection of policyholders and beneficiaries in preference to the safety and soundness of the insurer. This may be one of the issues envisaged in paragraph 3.14.

The principles enunciated in the Consultation are important and we strongly support them. We believe they might be expanded to reflect more fully general principles of better regulation, notably in relation to consultation on the introduction of new regulation, considering non-regulatory solutions and/or one-off regulatory interventions, ensuring regulatory consistency and conducting subsequent evaluation, including performance evaluation. These would also serve to reinforce the focus on transparency of regulation. We also believe that the FSA has been able to focus on improving its standards of service by setting specified levels of performance which it aims to meet, and that both the PRA and the FCA should be encouraged to adopt this approach.

Whilst we recognise that it will in appropriate cases be desirable to make available to the public information relating to authorised persons as a means of contributing to the advancement of regulatory objectives, as the Consultation acknowledges, there are countervailing interests which need to be taken into account. In determining what is appropriate in any particular circumstances, the regulators should be required to consider whether the same result could be achieved through other means, including making the information available on a basis which does not identify the firm.[1]

We also believe that it would be helpful for the PRA to take into account specific proposals being considered by the European Supervisory Authorities, which may impact on its proposed actions and on the firms it regulates, and the need to prevent regulatory arbitrage.

[1] We refer to this further in our response to Consultation Question 14 in the context of the FCA.

**6. What are your views on the scope proposed for the PRA, including Lloyd's, and the allocation mechanism and procedural safeguards for firms conducting the 'dealing in investments as principal' regulated activity?**

*Insurers*

The Consultation suggests that the PRA may be able to achieve effective supervision of insurers through a less intensive supervisory approach than for banks. This is welcome recognition that insurance business models are different from those of banks and that the failure of an insurance company is less likely to be systemically important than the failure of a bank.

As was shown by Equitable Life, whilst the failure (or near failure) of an insurance company can be catastrophic to the customers of that firm, it is unlikely to have any direct impact on other insurers along the lines of a run on the banks (albeit that in Equitable Life's case there may have been an indirect impact on confidence in with-profits business). Other recent insurance failures also demonstrate this difference between banks and insurers - Independent Insurance's downfall was caused by the actions of certain individuals; and both AIG and the monolines were brought down by non-traditional insurance business. The important point is that, to the extent that problems do arise in the insurance industry, they should be addressed by the PRA in a proportionate and timely way.

*Lloyd's Managing Agents*

We note that Lloyd's managing agents will also be regulated by the PRA, despite the fact that they do not carry insurance risk. We recognise that this approach provides a practical solution to the supervision of syndicates, which have no legal personality of their own – it will be particularly important to ensure that the burden of dual-regulation for managing agents is proportionate.

*Firms conducting the 'dealing in investments as principal' regulated activity*

In order to ensure the separation of prudential and conduct regulation for systemically important financial institutions, it is important that the PRA be empowered to designate firms that could pose significant risks to financial stability (or to PRA regulated entities within their group). The proposal that designation should only apply to firms which have permission to 'deal in investments as principal' does leave a very large number of firms in the uncertain position of being capable of being designated for PRA regulation.

An alternative policy approach might involve developing a narrower statutory definition of, or a more detailed set of factors to be considered in determining, systemic importance.

Limiting designation to the MiFID activity of 'dealing on own account' would be narrower than the 'dealing as principal' activity, although the same result is effectively achieved through the proposal for further restricting designation to investment firms within the BIPRU 730k prudential category. It would be helpful to understand whether this latter limitation is to be effected through primary or secondary legislation.

Clearly, the development of any additional criteria – possible minimum capital requirements, indicators for assessing systemic importance or interconnectedness with PRA regulated group

companies – will be of critical importance to firms "on the cusp" of PRA designation. It would be helpful for there to be a high degree of international consensus about the indicia for systemic significance or importance, and we would hope that the proposals will appropriately take into account the indicative criteria being used for the determination of systemically important financial institutions by the Financial Stability Board.

These further criteria should be an objective test, the application of which would mean that there would then be certainty that a firm meeting those criteria would be dual-regulated. There should also be some degree of certainty around the minimum period within which such a firm would be required to stay within the dual-regulated category, notwithstanding changes in balance-sheets or regulated activities.

We would welcome early consultation on the proposals, not least since, as the impact assessment acknowledges, dual-regulated firms will face numerous transitional issues, including the need to change IT systems, and possibly internal processes and organisation, in order to facilitate dealing with two regulators rather than one.

For the same reasons, we consider the proposed procedural safeguards in respect of the PRA's designation process, and its operation in practice, to be extremely important. In particular, in order to ensure the transparency and fairness of the process in individual cases, the firm should be given access to, and the opportunity to respond to, not only the PRA's decision, but to any submissions put forward by the FCA in the consultation process, and there should be a full right of appeal.

There will also need to be a transparent process in place to deal with regulated firms which become, or cease to be, systemically important and deserving of PRA designation. Clearly the regulators will need to consult, some form of notification will be required, and the firm will need to have access to, and an opportunity to respond to, the proposed decision.

For firms which may be subject to a change of regulation in this way, it is vital that there should not be any significant disparity or inconsistency in the applicable prudential rules on each side of the prudential regulatory divide, given the acknowledged need for adaptation of IT, systems and organisation involved in moving from single to dual-regulation. There will also need to be a level playing field between PRA firms which operate multilateral trading facilities (MTFs), and MTFs operated by recognised investment exchanges (RIEs), which will be FCA regulated.

Whilst we agree that the transitional costs for firms will depend on the size of a particular firm, with the larger firms expected to incur greater costs, we believe that the estimates for transitional costs set out in the impact assessment may err on the conservative side. We are somewhat surprised that the assessment should suggest that dual-regulated firms will face no additional costs in respect of ongoing compliance. This seems to us inherently unlikely even with a high degree of efficiency and congruency in processes involving both regulators. If the regulators make any regular use of their new powers to require information direct from firms, this alone would be likely to result in additional ongoing costs, even without the ongoing costs of additional staff for relationship management and compliance work.

**7. What are your views on the mechanisms proposed to make the PRA judgement-led, particularly regarding: rule-making; authorisation; approved persons; and enforcement (including hearing appeals against some decisions on more limited grounds for appeal)?**

*Rules*

The PRA's ability to make prudential rules is likely to some extent to be constrained by the move towards harmonisation at European level. Although greater use of principles in the application and enforcement of PRA rules will doubtless facilitate a judgment-led approach to prudential regulation, it will be important that the principles-based approach remains consistent with a purposive reading of the European rules, and does not become a form of gold-plating.

Whilst the absence of a power to give statutory guidance seems unlikely in itself to prove a significant issue, the statements of purpose will need to deliver sufficient certainty for firms, and to provide an adequate base for the PRA to seek to enforce compliance with prudential principles as a disciplinary rather than a supervisory matter, assuming that that is the intention.

If and to the extent that the PRA intends to provide non-statutory guidance in respect of the PRA's approach to application of rules and principles generally, that guidance should, so far as practicable, be transparent and available to the market, rather than developed through a series of ad-hoc responses to firm-specific issues. We would also encourage the PRA to adopt the guidance consultation process introduced by the FSA in October 2010 in respect of the issue of generally applicable non-statutory guidance.

Whilst we appreciate that there will be a need for firms to receive specific individual guidance, the PRA should avoid the creation of a body of internally generated guidance which informs the actions and approach of supervisors (an internal rule book), but is not available to firms.

This is also important in view of the PRA's proposed role as "prudential thought leader" – as indicated above, a consistent approach to the interpretation of prudential requirements as between PRA and FCA will be critical for firms which are capable of being designated for PRA regulation.

*Authorisation/approval*

We deal with issues relating to the authorisation and approval processes below under the section on Coordination.

*Enforcement*

A judgment-led approach should involve the objective exercise of discretion, having regard to the statutory and operational objectives, and the regulatory principles. It is important that there should be meaningful safeguards in respect of this approach.

We have some sympathy with the view that a full de novo hearing before the Upper Tribunal may not be the most appropriate means of reviewing some of the most technical judgment-based supervisory decisions taken by the PRA, specifically in relation to the maintenance and adjustment of appropriate levels of capital and liquidity to be held by systemically significant firms. It may be that a committee of experts, or possibly senior level PRA staff with appropriate expertise but not

involved in the initial decision-making, might provide a more appropriate forum for review of the proposed action in such cases, with a right to appeal to the Tribunal on limited grounds.

However, we do not believe that it would be appropriate for appeals from every supervisory decision taken by the PRA to be heard on limited grounds (akin to those which could be raised on a judicial review) as proposed. In particular, we strongly believe that decisions which affect the freedom of individuals to undertake their chosen employment within the financial services industry and those of a disciplinary or quasi-disciplinary character should have the full safeguards which attend the supervisory decisions which engage the statutory notice procedure under FSMA at present.

We look forward to commenting on the detailed proposals for the enforcement process, and the proposed structure and operation of the Proactive Intervention Framework, when these are published for consultation in due course.

**8. What are your views on the proposed governance framework for the PRA and its relationship with the Bank of England?**

*The relationship between the PRA and the Court of Directors of the Bank*

We have no comment on the proposals for PRA accountability to the Court of Directors of the Bank. We agree with the approach proposed in relation to proposed legislative provisions, and consider it would be appropriate for the Court to report annually on the discharge of its functions.

*The PRA Board*

We note that the PRA, though a member of the Bank of England group, will be operationally independent, and will be responsible for its statutory functions. The Governor of the Bank of England will be Chairman of the PRA Board, and therefore also a member of the executive committee, as indeed will the Bank's Deputy Governor, who will be the PRA's chief executive.

There are clearly substantial benefits to be derived from this arrangement, yet it also creates some interesting tensions given the significance of the Chairman's role in ensuring that the Board provides an appropriate mechanism for constructive challenge. The quality, experience and character of the non-executive directors will therefore be particularly important if the PRA Board is to be truly operationally independent from the Bank. We also agree that ensuring the involvement of non-executives in significant regulatory decisions on specific firms will more closely accord with principles of good corporate governance. This will be particularly critical if and where firms subject to such decisions will be limited in their ability to challenge such decisions.

In view of the potential for conflicts in connection with the Bank's responsibilities under the Special Resolution Regime ("SRR"), which the consultation acknowledges, consideration should be given to whether it is appropriate that the Governor should be entitled to vote on a decision to trigger the SRR in respect of a particular firm.

*Appointments to and dismissals from the Board*

We agree that the legislation should provide for appointments to (and dismissals from) the PRA Board to be made by the Bank with the Treasury's approval and we welcome the proposal to run the appointments process in accordance with the Code of Practice for Ministerial appointments. We agree that incapacity, serious misconduct and material conflict of interests should be the only grounds for dismissal.

**9. What are your views on the accountability mechanisms proposed for the PRA?**

*Accountability to Ministers and Parliament*

We would welcome a statutory requirement for the PRA to report to the Treasury in the event of a significant regulatory failure, and for that report to be laid before Parliament. We look forward to commenting on the details of the proposed trigger for the production of such reports. Whilst we acknowledge the desire to include confidential information where its disclosure is justified in the public interest, any such proposal will need to comply with the requirements imposed by the European single markets directives.

The mechanisms for the establishment of an independent inquiry under sections 14 to 18 of FSMA should also be retained. We expect that the Treasury Select Committee will also continue to examine such issues and to select its own subjects for inquiry.

We agree that the power under section 12 of FSMA to commission independent reviews of the PRA's economy, efficiency and effectiveness in using its resources should be retained, and that both the PRA and the FCA should be subject to full audit by the National Audit office and accountable to the Public Accounts Committee.

*Public accountability*

We agree that the PRA should have a system for the investigation of complaints, and that the legislation should provide for independent external scrutiny of complaints. It is clearly desirable that the process should be as transparent as possible, particularly given the proposals to limit the grounds for challenging certain PRA decisions.

**10. What are your views on the Government's proposed mechanisms for the PRA's engagement with industry and the wider public?**

*Consultation*

We strongly believe that the engagement of the regulator with industry and industry bodies can provide a valuable contribution to better and effective regulation, and in particular in fostering a better understanding of the way in which the PRA exercises its judgments, and in informing that approach. This is particularly important where the regulator does not have the power to give statutory guidance.

- *Consultation on rules*

  We would welcome the retention of the existing requirements to consult in FSMA, and particularly to consult publicly, when the PRA makes rules. We accept that this requirement might need to be waived in emergency situations and it would be helpful for the PRA to provide some guidance on the circumstances in which it would propose not to consult – in some circumstances, it may be appropriate to consider whether such rules should be maintained on a temporary basis pending consultation.

  Although it is clearly right that the PRA should not be required to carry out quantitative cost benefit analysis where this cannot be done meaningfully, it is none the less important that the regulators should publish a full and rigorous analysis of the potential impact of proposed rulemaking, even if some of the metrics are perforce qualitative rather than quantitative. We look forward to further clarification of the way in which it is envisaged that the regulators might apply proportionality in analysis as part of the CBA process.

*Engaging with practitioners and consumers*

We consider that the Practitioner Panel has performed a valuable role in enhancing the quality of regulation. Whilst we accept the desire for a more 'judgment-based' regulatory approach, we believe that this makes it even more important that there should be industry consideration (and understanding) of how far the PRA is giving due regard to the considerations set out in the legislation, meeting its statutory objectives and balancing its 'have regards' from an industry standpoint. We would be disappointed if the proposed arrangements were (in respect of either the PRA or the FCA) to diminish or restrict the role that the Practitioner Panel has to date performed.

We acknowledge that with the creation of a dedicated consumer protection regulator, there is less need for a standing consumer panel in respect of ongoing prudential regulation. Consumers may nevertheless be materially impacted by prudential regulation – and we note that the proposed approach relies entirely on the PRA identifying the materiality of potential consumer impact. We believe it would in any event be helpful if the PRA were also to be represented on the FCA's consumer panel.

The effectiveness of the proposed annual consultation process will very much depend on transparency and on the nature and extent of the information available. For the same reasons as have been cited in opposition to the imposition of a requirement for a quantitative CBA process, it may prove difficult for respondents to make any meaningful assessment of the extent to which the PRA has met its objectives without a considerable degree of transparency.

**11. What are your views on the:**

**i. strategic and operational objectives; and**

**ii. the regulatory principles proposed for the FCA?**

We strongly support the inclusion of the operational objectives, which are helpful in clarifying how the FCA will seek to protect and enhance confidence in the UK financial system.

The Consultation provides welcome clarification that the FCA will act impartially in discharging its consumer protection role, and stresses the importance that will be given to proportionality in its

approach, particularly in tailoring its actions and interventions to the specific sector being regulated. We agree that interventions in the pure wholesale and specialist markets should be different from those in retail and retail related wholesale markets and that different levels of protection should be afforded to retail customers than are extended to the professional market participants.

We repeat the remarks we made in respect of the regulatory principles at page 7 above in respect of the PRA. As already mentioned in that context, we also believe that it would be helpful if the FCA were required to take into account specific proposals being considered by the European Supervisory Authorities which may impact on its proposed actions and on the firms it regulates, and the need to prevent regulatory arbitrage.

We support the proposal that the FCA as conduct regulator should have regard to the importance of taking action to minimise the possibility of regulated business being used for purposes connected with financial crime.

**12. What are your views on the Government's proposed arrangements for governance and accountability of the FCA?**

We support the proposed arrangements for the governance of the FCA, and particularly welcome the proposals to legislate for Practitioner, Small Business Practitioner, Consumer and Markets Panels for the FCA, the replication of the existing complaints procedures, and the proposals for a requirement to report to the Treasury in the event of a regulatory failure. We note that it is envisaged that reports might include the disclosure of confidential information where this is justified in the public interest, and the need to reconcile this with the obligations under section 348 of FSMA in respect of confidential information, and specifically single market directive information.

*Should the FCA be accountable to the Public Accounts Committee?*

We agree that the FCA should be accountable to the Public Accounts Committee.

**13. What are your views on the proposed new FCA product intervention power?**

We are not persuaded that it is necessary to create a specific product intervention power of the kind proposed. The FSA is able to take action under its existing powers to impose requirements in respect of products, mandate minimum standards or restrict sales to certain classes of consumers, and could, we believe, intervene to block an imminent product launch or stop an existing product from volume sales.

Much will depend on how the circumstances for the use of the proposed power are defined, and we consider that the legislation should place some parameters around its use. It is important that the scope of any prohibition or intervention is absolutely clear, in particular in defining precisely the products or features which are targeted. This will be particularly critical in the case of products which may be packaged or embedded in other products, or where features may be common to different product types with wholly different risk profiles and characteristics. We look forward to commenting on more specific draft proposals in due course.

There must be absolute certainty about what is expected of firms, particularly since the FCA will be empowered to then declare that contracts which breach the ban are unenforceable. Parliament should also consider whether it is appropriate that the FCA should be able to render contracts which were entered into prior to the intervention unenforceable, whether through direct rule-making or informally through imposing some form of TCF requirement on firms to agree to cancel the contracts and refund customers.

It will be important to ensure that the proposed power will be fully aligned with the proposed intervention powers which are presently under contemplation in the context of the MiFID review. We also note that the European Supervisory Authorities have been vested with product intervention powers, and that there is therefore some risk of duplicative action which will need to be carefully managed.

Although we accept that a temporary ban should take effect immediately, we believe that the legislation should provide a mechanism for review of the exercise of the power, and for affected firms to adduce evidence in respect of such a review.

Enabling the FCA to provide for the unenforceability of contracts made in breach of its product intervention rules is an important power. We would expect such provisions to be consulted on, and consider that they should be prominently publicised when brought into force, and in respect of each intervention to which it is proposed to apply the power.

We welcome the acknowledgment that use of the FCA's product intervention power is unlikely to be appropriate in the professional or wholesale context.

We appreciate that the FCA's more proactive and intrusive approach is not intended to constitute any form of widespread pre-approval of products. There remains some risk that as use of the product intervention power becomes more widespread, consumers may interpret the fact that the regulator does not intervene in respect of other products as a form of tacit approval or endorsement of those products.[2] This is a moral hazard that the FCA will need to manage on an ongoing basis through its communications.

**14. The Government welcomes specific comments on the:**

- **i. proposed approach to the FCA using transparency and disclosure as a regulatory tool;**
- **ii. proposed new power in relation to financial promotions; and**
- **iii. proposed new power in relation to warning notices.**

In principle, we agree that disclosure of broader industry information and of trends in firm behaviour, both good and bad, is a potentially powerful tool which can lead to better regulatory outcomes for firms, markets and consumers. However, it is important to recognise that simply

[2] An analogous example of a similar syndrome is the way in which the fact that the SEC had conducted examinations and investigations, and did not detect the fraud, lent credibility to Madoff's operations and had the effect of encouraging additional individuals and entities to invest with him.

making information available can also, in some cases, cause confusion, and have a negative impact, or unintended consequences.

We believe that the FCA should be required to consider in each case whether disclosure is likely to make a material difference to its ability to achieve its strategic and operational objectives, and whether the same outcome could be achieved by disclosure which is not firm-specific. The regulator should also be required to consider whether the potential adverse consequences of disclosure (whether by the regulator, or by firms pursuant to a regulatory requirement) could be mitigated by deferring the disclosure.

It would be very helpful for firms to have greater clarity on the applicability of 'soft guidance' emanating from the regulator to their specific sector or business model.

*New power to direct firms to withdraw misleading financial promotions*

As with the product intervention power, we are not convinced that the FCA requires additional powers to direct a firm to withdraw or amend misleading financial promotions with immediate effect. It seems to us that this is readily achievable under (the threat of) the existing own initiative power, and that such matters would often be resolved informally through voluntary compliance. The proposed changes seem essentially to comprise an abbreviation of the period for the making of representations, at the discretion of the regulator, and the publication of the decision.

We agree in principle that, in certain circumstances, it may be appropriate that the FCA should be able to publish the fact that it has issued a written notice of a direction to withdraw or amend a particular promotion. However, given that it is envisaged that the financial promotion will remain out of circulation during the period for the process of making representations, we are not persuaded that (save in exceptional cases) it will be necessary to reduce the time for making representations.

There may be circumstances where the firm is unable to recall a financial promotion (hard copy magazines often have significant lead times for printing and publication). Whilst this may be a circumstance warranting the publication of the fact of a direction, the firm should not be subject to sanction for a failure to recall a publication that it is unable to prevent, although we accept that it would be appropriate for the firm to be required to take all reasonable steps to prevent circulation on receipt of an FCA direction.

*Early publication of enforcement action*

We have concerns about the proposal for early publication of enforcement action on several grounds.

- *Warning notices do not provide transparency at an "early" stage*

  Firstly, we do not believe that publication at the warning notice stage will in fact achieve the stated aim of highlighting potential issues to consumers or giving firms signals about behaviours the FCA considers unacceptable at a particularly early stage. The time within which the regulator may take action – the beginning of proceedings by the giving of a warning notice - against individuals was recently extended from two to three years by the Financial Services Act 2010[3]. We are aware of many instances where the FSA has issued warning

[3] We note that The Economic Secretary to the Treasury (Ian Pearson) had initially suggested that a "four-year limitation period is an appropriate time for the FSA to investigate individuals, whether they are suspected of misconduct or of performing a controlled function without approval".

notices against individuals after lengthy investigations, very close to the expiry of the period for commencing proceedings. The FSA's annual report for 2009/2010 noted that "even in enforcement, timescales are extended; case investigation and preparation takes time, and is only possible if we have first invested in supervisory and enforcement resources; the demonstrable successes of the last year build on two previous years of investment and preparation". The Enforcement Performance Report alludes to the "strong message about the length of time it had taken to progress some enforcement investigations" received in its feedback from firms.

It is therefore plain that publication at the warning notice stage is most unlikely to deliver warnings to consumers or updates to firms in any timely fashion.

- *The stated aims can be achieved more quickly, and as effectively, without adverse impact on individual firms*

  We are firmly of the view that the objectives of deterring other firms from similar behaviour or alerting consumers to potential issues can be achieved equally effectively, and much more quickly - without naming the individual or firm involved. Firms can be made aware of behaviours deemed to be unacceptable through the publication of 'soft guidance' or anonymised public statements, speeches, Dear CEO letters and examples of good and bad practices. One example of an early warning to the market was the FSA's warning on market abuse on 19 March 2008.[4] Speeches and consumer alerts can be, and are already, used to warn consumers of specific issues[5].

- *The proposal ignores due process*

  To the extent that what is published is to the effect that the FCA considers that the firm or individual has contravened a requirement imposed by or under the legislation, the publication of the summary of a warning notice will amount to a de facto public censure. Such censure is a disciplinary tool and should be used only in accordance with due process.

  Under the existing legislation, that due process includes the issue of warning notice, the right of the firm concerned to make representations and, if the FSA should decide to proceed with the public censure, a decision, which the person under investigation is entitled to refer to the Tribunal for a full de novo hearing. Publication of the warning notice is currently prohibited. At present, the FSA is entitled to publicise enforcement action which has resulted in the issue of a decision notice[6].

  There is a clear distinction to be drawn between a warning notice and a decision notice. Whereas the decision notice represents the FSA's concluded view of the evidence, the person under investigation having had an opportunity to present their case through an exchange of written and oral representations, the former is merely the first step initiating the enforcement process – the firm or individual may not have had any opportunity to make representations in respect of the FSA's factual account, let alone its conclusions. The proposals would effectively inflict the sanction of a public censure on the person under investigation before they had had a fair hearing.

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[4] http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/026.shtml
[5] http://www.fsa.gov.uk/Pages/consumerinformation/scamsandswindles/index.shtml
[6] It has been lawful for the FSA to publish decision notices since 12 October 2010, although its policy concerning such publication did not come into effect until 6 March 2011.

Furthermore, the threshold for issuing a warning notice is low, and does not require the FCA to assess the likely success of the enforcement action, which criminal prosecutors are required to do, but merely whether (in criminal terms) there is a prima facie case – whether the material is adequate to support the recommendation.

Publishing details of the fact of issue of a warning notice, together with a summary of the notice, as a mechanism for communicating more widely the nature of the FCA's concerns about the firm or the particular conduct will result in reputational damage to the firm. The intention is plainly to include the grounds on which action has been taken, which will clearly indicate that the FCA is critical of the firm's conduct. Such publication therefore amounts to a public censure in all but name, but without proper judicial process, and at a stage where the enforcement team's case may be wholly untested. It is not clear to us how this would fit in with the FSA's stated commitment to operating a process that is, and is seen to be, fair.

- *The adverse impacts may be significant, ultimately unjustifiable and irremediable*

  The FSA's Enforcement Performance Account for 2009/2010[7] records that of 114 cases concluded during the year (excluding Threshold Conditions cases), only 79 resulted in public disciplinary action. This suggests that under the scheme now proposed, 30% of individuals/firms would be at risk of suffering reputational damage as a result of the publication of warning notices, even though they were not, in the event, ultimately the subject of an adverse public disciplinary sanction.

  Research also suggests that the announcement of legal enforcement actions have a negative effect on share price, and more importantly, that pending cases have larger short-term negative impacts than cases of a similar nature with known outcomes, possibly due to high levels of uncertainty[8]. The initial detriment caused will not in any way be compensated for by the publication of a notice of discontinuance long after the initial warning notice.

- *Possible unintended consequences*

  Whilst some have suggested that one benefit of this proposal would be more cases being resolved at an earlier stage, we consider that it is equally possible that it might achieve the opposite result. Individuals and, perhaps more so, firms may find themselves more ready to contest proceedings, having already suffered the initial adverse publicity and therefore having (relatively speaking) little to lose by doing so in appropriate cases.

  We believe that the adverse impacts of so-called "early" publication of warning notices cannot be justified by the perceived benefits, and that the stated aim can be achieved through the disclosure of information that identifies key matters which form the subject of FCA concern but which does not identify the firm or individual under investigation. Such an approach would provide, in a far more timely fashion, sufficient information to the regulated sector and the public at large about the issues of concern without the same adverse impacts, and would maintain appropriate due process safeguards for the disciplinary process.

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[7] Although directly comparable information is not available for previous years, we are aware that of 153 cases concluded in 2008/2009 [90 in 2007/2008], 38 [13] resulted in private warnings, so at least 24% [14%] of cases did not proceed to public disciplinary sanction – figures for the number of cases discontinued are not available.

[8] Muradoglu, Yaz Gulnur, and Clark Huskey, Jennifer: The Impact of SEC Litigation on Firm Value. Available at SSRN: http://ssrn.com/abstract=1094948

**15. Which, if any, of the additional new powers in relation to general competition law outlined above would be appropriate for the FCA? Are there any other powers the Government should consider?**

Any consideration of the FCA's powers in relation to general competition law must have regard to the wider changes to the competition regime, including consideration of concurrency, which is currently under consideration and subject to consultation. We look forward to commenting on the more detailed proposals to be published following the BIS consultation on improving the use and coordination of concurrent competition powers against this background.

**16. The Government would welcome specific comments on:**

**i. the proposals for RIEs and Part XVIII of FSMA; and**

**ii. the proposals in relation to listing and primary market regulation**

*Wholesale and markets regulation*

The importance of a proportionate and tailored approach to regulation cannot be understated, and we strongly agree that a less interventionist approach will be warranted in respect of professional and sophisticated market participants.

We agree that the target audience for the product, or to whom the product is made available, will be relevant in assessing whether product intervention powers would be warranted. It is, however, not entirely clear to us that the scenario set out in paragraph 4.103 is the best example of a wholesale activity that has a retail dimension that would warrant greater intervention. Prima facie, trading in interest rate swaps as a way of managing interest rate risk arising from capped-rate mortgages that a firm is selling to retail customers would not appear to have any potential impact on those mortgage customers, save in so far as it affects the safety and soundness of the firm (a prudential rather than a conduct issue).

There have, of course, been some issues in respect of wholesale products which have been sold, some way along the distribution chain, to persons, such as local authorities, to whose profile the products may not have had the optimal alignment, with consequent retail impacts, and we note that the MiFID review is considering a revised classification for such authorities. We would welcome, in due course, a fuller iteration of the kind of retail impacts that it is envisaged would warrant a more intrusive approach to the conduct of wholesale activities.

*Enforcement*

We believe that the FSA has made significant strides in establishing a track record of successful insider dealing prosecutions and market abuse cases, and we agree that no substantive changes to the Part VIII powers are required, although it will of course be necessary to take into account the

outcome of the review of the Market Abuse Directive. We would be very disappointed to see any "streamlining" of the process which resulted in the removal or reduction of any of the safeguards currently in place to help ensure due process and a fair and impartial hearing.

The FCA will also need to have regard to the output of the European institutions, in terms of rules and interventions, in its regulation of markets.

*Listing and the UKLA*

No reasoning is given for the proposal to bring the listing regime set out in Part VI into the general legislative framework of the FCA. Currently the FSA's general regulatory objectives set out in section 2(2) do not apply to its discreet role as competent authority for official listing under Part VI because they are not treated as part of its general functions. The competent authority role has always been regarded as a discreet role based on the EU financial services directives' requirements for a competent authority for listing and with the FSA operating under the UKLA name for that purpose The FSA (and in future the FCA) then has a separate markets function in relation to regulating RIEs and MTFs generally, in relation to which its general objectives do currently apply. We think that careful consideration needs to be given to whether it is appropriate to apply the same structure, approach and objectives to the discreet UKLA role given that listed companies are not authorised persons.

We agree that the safeguards which are conferred by the warning and decision notice procedures are not necessary where a listing is being suspended at the request of an issuer. We acknowledge the proposal to provide the FCA with powers to sanction and suspend sponsors for breaches of UKLA rules and requirements, and stress that these should be subject to the existing enforcement and appeal mechanisms in FSMA. Likewise, we expect that the power to make rules for, and impose sanctions on, primary information providers would be subject to similar safeguards.

We do not agree that it is appropriate for the UKLA to have the power to require a listed issuer to have a skilled person prepare a report. A listed issuer is not an authorised person and therefore is not subject to the same conduct of business rules or supervisory arrangements as authorised persons. We think it would be more onerous for issuers to have matters investigated in this way.

*Recognised Investment Exchanges*

We agree that it is appropriate to retain the Part XVIII regime for recognised bodies pending the outcome of the MiFID consultation. Little detail is provided about the small technical changes which are being proposed, and we would welcome the opportunity to comment on the precise proposals in due course.

*European Representation*

As indicated elsewhere in this response, we believe that the engagement of the UK regulatory authorities with the European Supervisory Authorities is absolutely critical, and it is very important that the FCA and the PRA should be appropriately aligned with their European counterparts. We fully agree that the FCA must have the credibility to represent the UK in all matters covered by ESMA.

**17. What are your views on the mechanisms and processes proposed to support effective coordination between the PRA and the FCA?**

The effectiveness and efficiency of dual-regulation will very much depend on how well the PRA and FCA coordinate their activities, which in turn means that the two authorities will need to work consistently and transparently, coordinating their activities effectively. We generally support the legislative proposals to support effective coordination between the PRA and the FCA. However, these can only provide a framework within which the authorities must work. As the Consultation recognises, effective coordination will need to permeate the day-to-day operations of the two authorities, and also the interactions of the PRA and the FCA with the Bank and the FPC.

A key concern for dual-regulated firms is that they should know where responsibility lies for each aspect of supervision. The line between conduct of business and prudential issues is a grey one, and we are concerned that it will prove difficult to achieve a workable and clear demarcation between the two. There is a significant risk of overlap and inconsistency here which will need to be carefully managed, not just in the domestic context, but also at the European level. We therefore agree that the primary legislation should, so far as possible, allocate specific responsibility for particular processes and decisions related to dual regulated firms and groups.

One clear example of an area where clarity will be critical is in the supervision of with-profits business, where there is otherwise a risk that both the FCA and the PRA will try to fill the same space.

Implementation of the Solvency II Framework Directive (Solvency II), including the split between home state responsibility for prudential matters and host state responsibility for conduct, also illustrates the importance for passporting firms of having a clear definition of the dividing line between the responsibilities of the PRA and FCA from the outset. If the PRA/FCA split is not intended to match in all respects the home/host state divide under Solvency II, the differences need to be clearly identified and communicated.

*Effective, efficient and well-coordinated regulatory processes*

We strongly support the high-level principles for coordination set out in paragraph 5.6 of the Consultation, and believe that they should find some support within the legislative framework, possibly as "have regards" in conjunction with the statutory duty to coordinate, or as a description of the way in which the regulators should discharge that duty. We note that these principles effectively acknowledge that some overlap and duplication will be unavoidable and will need to be effectively managed. We believe in particular that the legislation should expressly require the authorities to have regard to the need to ensure consistency of rule-making.

*Statutory duty to coordinate*

Because there is a risk of overlap, duplication, and potentially, inconsistency, in respect of issues which have traditionally been seen as being both prudential and conduct in nature, the proposed statutory duty to coordinate is to be welcomed.

It seems to us that in some respects the triggers for the engagement of this duty are set at a relatively high level, which may therefore limit its effectiveness:

- *Material impact on achievement of regulatory objective*

  In respect of proposed action by one regulator (for the purpose of this example, the PRA), the duty to take the views of the other regulator (the FCA) regarding that action is not engaged unless the action may have a material impact on the achievement of the FCA's objective. If there were no consultation absent engagement of this duty, then it is difficult to see how the PRA would be equipped to make a meaningful assessment of the materiality of the impact of its actions on the FCA's achievement of its objective.

  It is also not clear whether the point of reference is achievement of the statutory objective (these are drawn at such a high level that it is difficult to see that the duty would be engaged save where a regulatory failure was imminent) or the operational objectives (if the trigger operates at the level of material impact on achievement of the objective in respect of an individual firm, then the duty would be engaged somewhat earlier).

- *Where necessary to take advantage of expertise*

  Necessity is again a very high threshold – we would prefer to see the bar lowered closer towards desirability, practicality or usefulness.

- *Congruent and efficient processes*

  We strongly support the inclusion of this limb of the duty. We note, however, that a desire to ensure congruency and efficiency, and avoid duplication, could well result in processes taking much longer. This can itself become a significant burden (as well as imposing significant costs) on firms, and we would like to see this limb of the duty recognise that if certain processes are not to burden firms unduly, they will need to be carried out in a timely fashion as well as congruently and efficiently.

*Memorandum of Understanding*

We believe it is critical that the PRA and the FCA should enter into an MoU which sets out in detail the framework for coordination and consultation between the PRA and the FCA. It is helpful that this should be a statutory requirement and it is clearly sensible that whilst the legislation should include a non-exhaustive list of key areas where coordination is required, the authorities should retain flexibility to include additional matters in the MoU, and to amend it.

It would be helpful if the MoU also sought to address those areas where the PRA and the FCA will have common interests and consider how best to manage duplication in those areas, both in terms of day-to-day interactions with firms, but also in respect of policy and guidance. The latter will be particularly important with regard to the interpretation of European prudential requirements.

We agree that the requirements for annual review and for revised MoUs to be laid before Parliament will help to enhance transparency and accountability.

*Cross-Membership of Boards*

We believe that the proposal for cross-membership of boards will enhance strategic coordination between the two authorities, and that this will be an important factor in helping each authority in taking its "tone from the top" and establishing a culture of cooperation. We do not, however, believe that this should substitute for earlier input, coordination and engagement between the two authorities in relation to more granular decision-making, in order, for example, to ensure consistency in rule-making.

We also agree that it is preferable to preserve the demarcation between the two bodies by restricting the Chief Executive of one regulator from voting on firm-specific decisions being made by the other. This section of the Consultation paper alludes to a potential moral hazard which in fact underpins the whole of the coordination and consultation processes: the primary aim of the regulatory reforms is to create two independent regulators with clear and differing responsibilities and focus. It is therefore important that in coordinating their activities, the new regulators do not compromise their own focus on their different objectives. Clear avenues for the transmission of information and the implementation and maintenance of congruent, efficient and responsive systems are clearly desirable, as is planning for, and forewarning of, issues. However it is important that the two regulators do not strive for a common perception of issues and horizon risks which could compromise the independence of the two bodies.

**18. What are your views on the Government's proposal that the PRA should be able to veto an FCA taking actions that would be likely to lead to the disorderly failure of a firm or wider financial instability?**

We view the PRA veto very much as a tool of last resort to ensure financial stability which is what we understand the Consultation to be suggesting. We believe it is important that where financial stability is in issue, there is a mechanism for cutting through regulatory deadlock, and it is clearly desirable to avoid the kind of lengthy internecine disputes over regulatory jurisdiction into which US regulators have occasionally been drawn.

The somewhat unfortunate by-product of granting one regulator this kind of limited primacy – albeit in the area of its prudential expertise - is that this could lead to a misperception that the FCA is a lesser regulator –we believe it is important that the legislation should expressly recognise that the PRA and FCA will be equal in status as suggested in paragraph 5.6.

We agree that transparency in respect of the use of the power of veto would in principle be helpful, but stress that the timing of the notification to Parliament should remain subject to public interest issues - we note in particular that there is some potential for the firm that is the subject of the proposed action to suffer reputational risk as a consequence of such publication, and that if the intervention is based on the potential for disorderly failure of the firm, premature publication would be capable of ensuring the failure that the use of the veto sought to prevent.

It is not presently clear to us that there is any proposed mechanism for the regulators to resolve other disputed issues, for example differing policy approaches to European legislative requirements. We believe this to be a significant area of risk, since although the strategic objectives of the PRA and the FCA are relatively closely aligned, the separate operational

objectives are very different in focus. This is no doubt something that could be dealt with in the context of the MoU.

**19. What are your views on the proposed models for the authorisation process – which do you prefer, and why?**

The authorisation process should be practical and work efficiently for applicant firms, without creating inappropriate barriers to entry to the financial sector.

It is clearly sensible that the FCA should operate the authorisation process for those firms for which it is the sole regulator in much the same way as the existing Part IV process under FSMA, ensuring that both prudential and conduct requirements are met.

It is in respect of dual-regulated firms that effective coordination between the PRA and the FCA in relation to the authorisation process will be essential. An optimal approach would have as its outcome the reduction of duplication, the achievement of returns through a critical mass of expertise and the development of a centre of excellence, the reduction or removal of arbitrage or gaming, and the reinforcement of credibility through consistency of standards.

It seems to us that each of the current proposals are somewhat less than optimal because they focus on institutional rather than functional approaches. The focus should be less on where this process is carried out, and rather on the standard to be applied, how best to ensure that all stakeholders can contribute or participate, and whether the technology can be used to achieve the optimal outcomes.

In functional terms, this would comprise the development of common admission criteria, the common collection of information, and ideally a common technical platform access to which could be limited on a need to know basis. Some other jurisdictions operating a twin peaks regulatory system have achieved some of these aims – the Netherlands, for example, works on the basis of a single application form. It seems to us that considerable synergies and efficiencies could be achieved through a shared services function, and that this would also help to ensure operational coherence.

A key potential area of risk for firms, which is not directly touched on by the Consultation, is the question of regulatory notifications, and whether information provided to one authority will be treated as satisfying any obligation to provide the same information to the other authority. This would be a problem for firms in relation to each of the approaches to authorisation proposed in the Consultation, since it is envisaged that even on the alternative approach, both the PRA and the FCA would have the power to request further information direct from, and interact directly with, applicants. We feel strongly that firms should not be required to second-guess the regulators, nor should they be exposed to the risk of regulatory sanction for any failure to provide information specifically requested by one regulator (e.g. the PRA) to the other (e.g. the FCA), particularly where this is the direct consequence of the design of a regulatory processes involving the participation of both regulators.

We have the following comments on the current proposals:

*The lead approach*

This proposal envisages the establishment of authorisation processing capability in both regulators and carries the risk of producing different PRA and FCA authorisation outcomes. There will be a significant degree of duplication since there will be considerable common ground to be covered in each application. There seems to us a greater risk of divergence between the prudential standards applicable to dual-regulated firms and those applied to FCA-only regulated firms since there will be little or no line of sight between FCA and PRA gateway prudential standards.

It is also not clear how the designation of sole or lead jurisdiction for one authority under each of the threshold conditions would work in practice. We are not clear who would be responsible for designation, not whether responsibility would be sole or joint where one regulator took the lead on an issue where there were obvious prudential and conduct overlaps.

*Alternative approach 1*

This proposal has the considerable merit of reducing duplication in authorisation processing capability. It seems to us that it has the potential to result in one of two outcomes. It could lead to substantively identical prudential criteria and process (for both dual-regulated and FCA regulated firms), which would in our view be a significant benefit. There is some risk that certain applicants on the cusp of the PRA/FCA divide may seek to game the process to gain entry through a potentially less demanding FCA only gateway, although this risk arguably exists in the so-called "lead proposal". It is conceivable that the FCA may prove less than wholly transparent and authoritative in interpreting PRA requirements to candidate firms, and we wonder whether the PRA, as prudential thought-leader, would be willing to rely on the FCA to operate PRA entry criteria as lead authoriser.

*Alternative approach 2*

This approach would require both prudential and conduct standards and processes to be identical if regulatory arbitrage is to be limited or avoided. Substantive duplication of authorisation processing capability would also be involved, but in this case that capability would not be limited to the specialism of the regulator, so that the PRA would be required to have conduct as well as prudential authorisation capability. It seems to us that this approach carries the risk of even greater variation between admission standards.

As indicated above, our view is that for dual-regulated firms, the optimal approach would be a single application form, with a shared services function to reduce duplication and help to ensure operational coherence.

We also believe that it is critical for consumers and firms that there should be a single register of authorised persons and approved persons. If a shared services function is not considered feasible, then we believe that of the three options proposed, the alternative approach 1 is likely to deliver the best outcomes, although as outlined above, we have concerns about each.

**20. What are your views on the proposals on variation and removal of permissions?**

We believe that it would be sensible for the process for applications for Voluntary Variation of Permission (VVoP) to be aligned with the authorisation process, as finally determined.

In principle we agree that the PRA and the FCA should each be able to exercise Own Initiative Variation of Permission (OIVoP) powers similar to those currently exercisable by the FSA, but we strongly believe that in respect of dual-regulated firms, the PRA and the FCA should be required to consult and reach agreement with each other before any exercise of OIVoP powers. The fact that the Consultation refers to the PRA veto in this context is a clear indication that consultation should be mandated. We would expect the safeguards and controls which currently apply to the exercise of those powers would be replicated in the amended legislation.

**21. What are your views on the Government's proposals for the approved persons regime under the new architecture?**

Close and effective cooperation between the PRA and the FCA, and a high degree of congruency, efficiency and expedition, will be of fundamental importance in the context of the approvals process. The volume and frequency of approvals applications is exponentially greater than applications for authorisation, and a flawed, lengthy or uncertain process, or regulatory disagreements over issues of jurisdiction and scope, could result in firms being left with critical positions unfilled, potentially unable to carry on certain regulated activities, while the regulators work their way through the processes.

It is clearly right that the FCA should have full power to designate controlled functions for those firms for which it is sole regulator and to approve individuals to undertake those functions, in each case on a similar basis to the current approved persons regime operated by the FSA.

In respect of dual-regulated firms, however, we have concerns about the combined effect of the proposal to split lead responsibility for controlled functions between the PRA and the FCA in line with their objectives, and the proposal to confer on each authority the power to specify new controlled functions.

It does not seem to us that the majority of the existing controlled functions can readily be divided between functions related to prudential soundness of the regulated firm and conduct. The example given of the CEO is a case in point. The culture and tone of a firm is very much determined by its Chief Executive, and this will be an issue of critical importance to the conduct regulator. Whilst we certainly believe that the approval of a CEO is a clearly a matter on which the PRA and the FCA should consult, we do not believe that the final say on the approval decision should lie with the PRA in circumstances where the FCA is opposed to the approval.

As in the case of the authorisation process, we would strongly advocate a single application and point of entry, and the use of a shared processing service. We note that the FCA's role as competent authority for money laundering, and as the body which maintains key links with other law enforcement bodies in respect of financial crime, with access to intelligence data, would suggest that it would likely be the appropriate body to conduct due diligence checks unless this function is shared.

We also believe that the approvals process will only work in practice if the PRA and the FCA are required to reach agreement on how the approved persons regime should operate, and on the specification of any new controlled functions. If the PRA and the FCA are free to create controlled functions in the same space, there must be a significant risk that there will be inconsistency, which may make it impossible for firms to fill the position. It will be necessary for there to be absolute clarity about whether particular controlled functions are the concern of only the PRA, only the FCA or both.

It would be particularly helpful if there could be a high degree of coordination over arrangements to interview candidates for approval to perform significant influence functions, since these are very likely to concern both the PRA and the FCA.

**22. What are your views on the Government's proposals on passporting?**

As conduct regulator, the FCA should clearly have responsibility for the passporting process and administrative oversight of firms which have established branches in the UK under the passport. However, we fully accept that the PRA should be responsible for, and equipped to liaise directly with the home state regulator in relation to, the setting of liquidity standards within the UK in respect of deposit taking and insurance businesses. The Consultation does not make it clear which authority would be responsible for receiving passport notifications relating to the inbound provision of services on a cross-border basis by EEA authorised firms. It is clear that the FCA will have responsibilities to discharge in respect of all such notifications, and a single point of entry has the considerable advantage of clarity and consistency.

It is not entirely clear whether it is intended that responsibility for liquidity standards within the UK in respect of incoming investment firms should be shared between the PRA and the FCA, or should fall to the PRA in all cases. It seems sensible that the PRA should consider the potential financial stability impacts of cross-border firms in respect of the business carried on within the UK. This does however underscore the need to ensure consistency of prudential standards in relation to liquidity issues as between the PRA and the FCA in order to ensure a level playing field between UK and incoming investment firms.

The Consultation implies that for dual-regulated firms wishing to establish branches in other EEA Member States under the passport, regulatory responsibility will be divided between the PRA, which will be responsible for issues relating to financial soundness, and the FCA, which will be responsible for all conduct issues. Whilst this mirrors the domestic UK approach, it is not clear which authority would receive passport notifications in practice. The ideal would be that all such passport notifications should be received at a single point on a centralised basis, and for a single form of notification to be used. This could be achieved either through the use of a shared service

function, as we have suggested above in relation to authorisation, or through the FCA, which would then need to consult the PRA on issues relating to financial soundness.

**23. What are your views on the Government's proposals on the treatment of mutual organisations in the new regulatory architecture?**

The Government made commitments in the Coalition Agreement to "foster diversity in financial services" and "promote mutuals". We are inclined to agree with the Treasury committee that the fostering of diversity will only be possible if both the Government and regulators take the mutual sector into account from the very beginning of the policy making process. It seems to us that a requirement that the PRA and the FCA should carry out a cost-benefit analysis to determine the impact of proposals on mutually-owned institutions provides less proactive policy input than a "have regards" requirement enshrined in the legislation. This will be of particular significance since the Consultation rules out any need for the PRA to have any regard to the promotion of competition in discharging its functions.

**24. What are your views on the process and powers proposed for making and waiving rules?**

We strongly believe that consistency in rule-making will be critical to the success of the new regime. We understand that the intention is that the PRA should become the prudential thought leader, effectively a centre of excellence in relation to prudential regulation. Nevertheless, the FCA will be a prudential regulator in its own right, and, for firms falling with the "capable of PRA designation" category, consistency of prudential rule-making will be critical.

Whilst clearly the regulators will be constrained by their statutory objectives – so that the PRA could not make rules primarily aimed at conduct – it is critical that there should be a clear division of responsibilities between the regulators. We note that in the context of actuaries and auditors, the Consultation acknowledges the difficulty of classifying existing rules as conduct or prudential. As previously mentioned, the issue of whether FSA rules relating to the management of with-profits business should properly be classified as "prudential" will need to be resolved before the new framework takes effect. Proposals for dealing with Part VII transfers will also need to take appropriate account of the interests of FCA, especially in life insurance transfers.

As indicated above, we also believe that the proposals that would enable the PRA and FCA to both make rules that apply to the same functions (for example, systems and controls) within dual-regulated firms carry the risk of duplication or inconsistency of requirements in areas of overlap. This is because each regulator is working to different objectives.

We note that it is envisaged that the FCA's prudential regulation will focus less on acting to avoid the failure of firms and rather on preventing consumer detriment. We are concerned that in the pursuit of differing statutory objectives, the FCA and the PRA may over time develop different interpretations and approaches to prudential regulation, and to the implementation of the developing European rulebook. This is unlikely to prove a significant issue for the great majority

of FCA regulated firms who will be supervised mainly through baseline monitoring and responding to alerts. For the smaller population of 'prudentially significant firms', however, who may be on the cusp of the PRA/FCA divide, this is a significant issue. We trust that the forthcoming FCA publication will give some consideration to how this could best be managed.

We do not believe that the mere fact that there is cross-membership of Boards will, on its own, be sufficient to ensure that there is enough, or early enough, input into the rule-making process in respect of areas of common interest. We believe that serious consideration should be given to making prudential rules in these areas, and delivering soft guidance on those prudential issues, jointly. It does not seem to us that this would offend against the twin peaks principle, and, as the European Supervisory Authorities begin to develop binding technical standards, there will clearly be a need for consistent interpretation and implementation of those standards.

Failing a joint rule-making power, we would advocate that the PRA and the FCA should each establish a rules committee whose membership would include representatives from the other authority, to ensure that issues relating to common rules are properly debated at an early stage in the rule-making process. The fact that the PRA will be able to veto a rule proposed by the FCA if it considers that it would risk the disorderly failure of a dual-regulated firm or affect financial stability more widely highlights the need for early engagement and consultation.

In having regard to the need to ensure the consistency of rule-making (see Q17 above), we believe that, where it has not been considered possible or appropriate to ensure consistency of rules (whether in relation to firms on the cusp of the PRA/FCA prudential divide, or in respect of areas of overlap such as in respect of systems and controls in respect of dual regulated firms), the authorities should be required to explain and justify why different rules have been made.

It is not clear how disagreements regarding rules (on issues other than impact on financial stability) are to be resolved. For example, if the FCA considers that the PRA is venturing into "conduct" territory, it is not clear what recourse it may have. In areas of overlap (e.g. systems and controls), it is also not clear how firms would be expected to deal with conflicts between the rules of the PRA and the FCA, or where the combined effect of the rules is unduly burdensome. Judicial review is a fairly blunt mechanism and the current complaints procedure results in recommendations but no means of ensuring change.

Whilst we recognise that many concerns can be raised in the course of the consultation process for new rules, it is also true that firms are struggling to ensure that they provide meaningful input to the welter of proposals for new regulation in the UK, at the European level, and internationally. There must, over time, as the PRA and FCA develop their own rulebooks, be a real risk that firms will face considerably more regulation (or "over-regulation") than under the current regime.

Clearly, each authority should be able to consent to the modification or disapplication of the rules that it makes. We agree that, in the case of a dual-regulated firm, the authority wishing to issue a direction in respect of a modification or disapplication of rules should consult the other before issuing the direction.

**25. The Government welcomes specific comments on:**

**i. proposals to support effective group supervision by the new authorities – including the new power of direction; and**

**ii. proposals to introduce a new power of direction over unregulated parent entities in certain circumstances?**

*Group supervision and the power of direction*

We agree with the basic premise that, where 'solo' prudential supervision of firms within the consolidation group is split across the PRA and the FCA, the authority responsible for consolidated supervision should have a power of direction over the other authority. However, the power of direction should only be exercised as a last resort; it is clearly preferable that the authorities should achieve a workable approach to consolidated supervision through prior consultation. We agree that an authority should be under a duty to consult with its counterpart before a direction can be issued.

We also agree that the power should only be available where a consolidation group exists under EU law and that it should be exercisable only where necessary to ensure effective consolidated supervision. We also believe it would be preferable for affected firms to receive warning of the potential issue of a direction by the PRA or the FCA, well in advance of receiving a copy of a direction.

There will clearly be circumstances in which it would not be appropriate for a direction to be publicly disclosed, and we believe the firm should be given the opportunity to make submissions on the question of publication. The Consultation acknowledges the risk of unintended consequences which may flow from the use of the direction power, particularly where the group is complex and includes both financial and non-financial firms. We look forward to responding to a further consultation on the circumstances in which disclosure would be capable of being withheld in the public interest and on the associated proeedures and safeguards.

We are aware that there is considerable concern amongst our clients in relation to how the proposed UK specific arrangements will relate to arrangements with regulators in other EU member states regarding consolidated supervision issues. In addition, there are also concerns about how these arrangements will relate to the international supervisory colleges. We are aware that whilst some global institutions are strong supporters of supervisory colleges and the FSB model for such colleges, there is a real concern that, as it is, the FSB colleges (which broadly opt for representation from jurisdictions in which the group has the most significant presence, and/or which are the most significant for the firm) do not match the European colleges (which opt for equality of representation). It is important that our national regulators should be optimally aligned to make effective contributions to supervisory colleges.

- *Specific considerations for insurers*

  Once Solvency II takes effect (which seems likely to coincide with implementation of the FSA reforms), we think it inconceivable that the PRA should not assume responsibility for the supervision of groups that include one or more insurance companies, even if the group also includes firms which are to be regulated solely by the FCA. Group capital requirements and other aspects of group supervision fall clearly within the ambit of prudential supervision.

Whilst the FCA might have an interest in specific matters, it would not have the expertise needed to assume overall responsibility in this area.

Solvency II establishes, for the first time in the insurance context, the role of a group supervisor to take responsibility for the supervision of insurance groups across the EEA. Colleges of supervisors will also be established, with representatives from relevant EEA states. It will be important that coordination arrangements between the FCA and the PRA support UK representation in colleges or performance of the role of group supervisor, where that role is assumed by the UK.

*Unregulated holding companies*

The proposed power of direction over unregulated parent undertakings which control and exert influence over authorised firms is a significant change, conferring regulatory powers in respect of the wider unregulated community.

Whilst we acknowledge that the regulator will have a legitimate interest in an unregulated parent which controls a regulated firm, this is already catered for in provisions relating to the controllers (e.g. under the Acquisition Directive) and in the designation of the CF00 controlled function for parent entities (or individuals within parent entities) who exercise a significant influence over the regulated firm by virtue of the fact that their decisions or actions are regularly taken into account by the governing body of the regulated firm.

No case is made to evidence why this additional, potentially draconian, power is needed, and the Consultation provides little by way of specificity in respect of either the conditions of exercise, or the scope, of the power. Given that the entity concerned is outside the regulated sector, we believe that the exercise of this power should be limited in practice, and proper safeguards will be required.

We believe that it is important that the regulator be required to have exhausted all other available regulatory tools in relation to the relevant authorised firm before the exercise of this power is considered. We are also of the view that the proposed test – that the regulatory authority considers it 'desirable' for the purposes of fulfilling its statutory objective – is set too low, given that the person subject to the powers is unregulated.

The Consultation does not provide any specificity regarding the potential scope of such directions, save to suggest that the same level of oversight and supervisory powers could be applied as are available in respect of the regulated entity. We would like to understand more precisely what it is envisaged that the regulator would be able to direct the parent to do, and whether it is envisaged that the direction should extend beyond the part of the firm's regulated business.

Whilst we welcome the proposed publication of a statement of practice outlining how the power of direction will be exercised and look forward to responding to the consultation on the further details of the proposed power and the related safeguards, we believe that issues relating to the scope of the power and the conditions of its exercise should be dealt with in primary legislation rather than left to regulatory rule-making,

We welcome the proposal to give a notice warning of the potential application of a power of direction, but we believe that the full safeguards available to firms under the current statutory notice procedures should be available. In particular, we strongly believe that an unregulated person should be entitled to a full de novo hearing, rather than to a limited right of appeal to the Upper Tribunal.

We assume that the PRA's power of veto would apply to circumstances in which the PRA or the FCA is required to consult with its counterpart prior to issuing a direction affecting a dual-regulated firm or a group of which such a firm is part.

Finally, in the insurance context, we note that any proposals in relation to unregulated holding companies will also need to be consistent with Solvency II requirements, including the requirement that anyone who runs an "insurance holding company" (as defined) should be fit and proper.

**26. What are your views on proposals for the new authorities' powers and coordination requirements attached to change of control applications and Part VII transfers?**

We believe it would be preferable for all change of control applications to be submitted to a single entry point, whether through a shared services system or to the FCA, but that there should also be a statutory duty for the regulators to consult in the case of dual-regulated firms. The proposal that applications involving a proposed change of control relating to a group that included PRA-regulated firms and firms which are prudentially regulated on a solo basis by the FCA would need to be submitted to each of the FCA and the PRA is likely to be duplicative and cumbersome for market participants.

As conduct regulator, the FCA will have a role in all change of control applications, and will, as the Consultation envisages, have the ability to veto or impose restrictions on the grounds of risks of money laundering or terrorist financing. The FCA will presumably retain responsibility for civil and criminal enforcement proceedings in relation to alleged breaches of the change of control regime.

We question whether the PRA should be able to veto an application in respect of an FCA solo regulated firm, where it has concerns about the post-acquisition entity's ability to meet prudential requirements imposed by the PRA in respect of dual-regulated entities within the same group. Other than to avoid potential embarrassment, we are not sure why change of control applications should not be dealt with separately by the FCA and the PRA in such cases, consistent with their usual areas of responsibility and notwithstanding the risk that some aspects of an acquisition are approved and others not. Similar risks arise on the proposed acquisition of a group that includes firms established in more than one jurisdiction. It should be open to the parties, if they so choose, to restructure their transaction to encompass only those acquisitions which are approved.

It is not clear whether the suggestion that the FCA should have regard to the PRA's prudential assessment (where the PRA has granted prudential approval to a change of control involving a dual regulated firm) implies that the fact of PRA approval should prevent the FCA from declining to approve the change of control on the basis of prudential concerns in respect of FCA solo regulated firms within the same group. This would clearly amount to a usurpation of the FCA's duties as prudential regulator, effectively giving the PRA a fiat to direct the FCA in respect of its prudential assessment.

- *Insurers*

  Whilst the proposal that change of control applications relating to insurers should be considered by the PRA, with a requirement to consult the FCA, would be welcome in that it would mean that a single application would be required, we believe that the same result could also be achieved through the single point of entry as suggested above.

For groups that include both dual-regulated firms (e.g. insurers) and firms that are only regulated by the FCA (e.g. insurance intermediaries/brokers), it seems that the FCA will be required to refuse an application in relation to the FCA-regulated firm if the PRA objects to the proposed controller of the dual-regulated firm on prudential grounds. As indicated above, we believe it should be open to the parties, if they so choose, to restructure their transaction to encompass only those acquisitions which are approved.

*Part VII transfers*

We agree that the current arrangements for transfers of insurance and banking business under Part VII of FSMA "work well" insofar as it relates to the Part VII mechanism of transferring business under a court-approved scheme. However, we are particularly concerned that the proposed reforms do not act as an impediment to the Part VII process.

The Consultation proposes that the PRA should take the lead on all Part VII applications. Whilst it is difficult to set any rules about which of the FCA and PRA will be most interested in a particular transfer, we would expect that whilst the PRA should possibly take more of a lead on general/reinsurance transfers, the FCA is likely to have the greater interest on life transfers, especially where with-profits business is involved and matters relating to Treating Customers Fairly are key, particularly in communications to policyholders. The most important thing for insurers is that the Part VII mechanism should be clear and should not introduce yet more delay for clients. It would certainly be preferable to have a single process (albeit involving consultation between the two authorities) rather than two parallel processes.

**27. What are your views on the Government's proposals for the new regulatory authorities' powers and roles in insolvency proceedings?**

*Insolvency proceedings*

Whilst we agree that the PRA should have a right of veto over FCA decisions that risk disorderly failure of a firm or wider financial instability, we also consider that there should be a duty to consult not just on the FCA, but also on the PRA in respect of firms within groups that also include FCA solo regulated firms.

With regard to the voluntary winding up of a life insurer, the Consultation implies that both the FCA and PRA might make a valid claim to possession of the power to approve the winding up – the FCA because the original purpose of the power was "to protect policyholders", the PRA because there are “clear prudential, and possible financial stability, implications” associated with a winding up. We think that the better view is that policyholder protection in this context is mainly about ensuring that liabilities have been appropriately assessed and will continue to be met. This being the case, the primary interest should lie with the PRA.

*Actuaries and auditors*

We agree that the existing legislative provisions relating to the disclosure and flow of information between actuaries and auditors of regulated firms and the FSA – which enable the FSA to benefit from the expert opinions of these professions - will remain in place and available to both the FCA and the PRA.

Giving rule-making powers in relation to actuaries and auditors to both authorities will inevitably result in the imposition of a greater regulatory burden on - and increased regulatory exposure for - actuaries and auditors - who, in respect of dual-regulated firms, will be potentially responding to two regulators - the costs will ultimately be passed on to the authorised firms (and thence to the consumer). It is not clear what the scope of these rules will be - but no case has been made for extending the scope of the existing rule-making power in section 340 of FSMA.

The proposal that the PRA should be responsible for rules that cannot easily be classified as conduct or prudential because it is "the prudential authority" does not fully take into account the fact that the FCA will in fact be the prudential regulator for the majority (by number) of firms (admittedly those deemed as having less potential impact on financial stability). Nevertheless, this approach would appear to reduce the scope for duplication - particularly when coupled with the proposed requirement that the relevant authority consult the other regulatory authority and the impacted firms themselves in relation to enactment, monitoring and enforcement of its own rules.

We assume that the disqualification power will be available to both PRA and FCA and will effectively reflect the existing power under section 340, but be clarified to enable the authorities to disqualify any individual professional they deem to have failed to comply with the duties under FSMA, irrespective of whether they were appointed as an individual or were representing their firm.

No very clear case seems to have been made for applying these provisions to auditors or actuaries acting for the members of Lloyd's of London who, although not authorised persons themselves, are regulated as part of the market - but we accept that it is a logical extension of the proposals in 3.28 - 3.30 which would make the Society of Lloyd's and Lloyd's managing agents dual-regulated firms (with PRA responsible for ensuring the adequacy of members' resources), and members' agents and advisers, and Lloyd's brokers FCA-regulated firms.

**28. What are your views on the Government's proposals for the new authorities' powers in respect of fees and levies?**

We would support the proposal to collect fees for both the PRA and the FCA through one organisation under a non-statutory arrangement.

We agree that it is important that the PRA and the FCA should use their resources efficiently in order to control their costs. This will inevitably be one of the driving factors underlying the need for effective coordination between the two authorities. In particular, we believe that an approach involving a single service function to process applications for authorisations, approvals, passporting, changes of control and the like in respect of dual-regulated firms, would be likely to involve significant cost savings.

**29. What are your views on the proposed operating model, coordination arrangements and governance for the FSCS?**

We note that there are various European proposals in contemplation, including proposals to amend the Investor Compensation Scheme Directive and the Deposit Guarantee Scheme Directive, and a proposed Insurance Guarantee Scheme Directive. The outcome of these legislative initiatives will clearly impact on the current proposals, and it is not inconceivable that significant changes will need to be made to the proposals made in the Consultation, and perhaps to the design, structure, capacity and funding of the scheme (or schemes).

The operation of the scheme will be a matter for the FSCS and the micro-prudential regulators. The division of rule-making powers between PRA and FCA is clear, but close coordination will be critical, and as indicated above, we believe there would be considerable merit in the PRA and the FCA each establishing a rules committee whose membership would include representatives from the other authority, to ensure that issues relating to common rules are properly debated at an early stage. We also support the proposed requirement for the FSCS to put in place MoUs with the PRA and the FCA which will strengthen transparency and accountability.

The PRA and the FCA will also need to develop well coordinated mechanisms to ensure efficient and effective joint oversight of the FSCS.

**30. What are your views on the proposals relating to the FOS, particularly in relation to transparency?**

We agree that the Financial Ombudsman Scheme ("FOS") should remain an alternative dispute resolution service, and that the role of FOS is to provide access to swift and impartial resolution of disputes between firms and customers, free to consumers to use, as an alternative to the courts.

It is important to note that the FOS is required to consider complaints on the basis of what is, in the opinion of the FOS, fair and reasonable in the circumstances particular to that case, and that complainant, rather than by reference to ordinary legal principles and/or regulatory rules. As a result, the precedent value of a single FOS decision is in reality very limited. Yet, there is a growing regulatory expectation that firms will give precedent value to compensation awards made by the FOS in individual cases, taking them into account and carrying out root cause analysis.

Financial services providers need predictability and certainty. If they are fully compliant with applicable current rules and guidance and/or relevant legal principles, the FOS should not have the discretion to find against them. This is particularly important given that there is no appeals process from a FOS Final Decision. In circumstances where a firm fundamentally disagrees with decisions made by FOS and therefore does not feel it can take them into account in its complaints handling or reflect them in respect of its front book, and where the FOS (and/or FSA) is not engaging informally with the industry to resolve an impasse, other than resorting to the courts, the only solution has to date been to try to use the Wider Implications process.

Whilst the creation of the Coordination Committee consisting of the FSA, the OFT and FOS is welcomed as a vehicle for promoting alignment more effectively between the regulators and the ombudsman service where there are emerging risks and in the handling of mass claims, the proposals do not appear to involve engagement with the industry, nor is it clear that the new process necessarily furnish firms with any mechanism for escalating these concerns.

Because of the lack of precedent value in individual cases, and the issues referred to above, we are not clear what the proposal to publish FOS decisions will mean in practice, nor what it is intended to achieve. In these circumstances, it is difficult to comment meaningfully on the proposal, and we believe that this is a matter which would merit clarification in the forthcoming White Paper and should not be relegated to a FOS consultation on the applicable principles for publication. We also believe that there would be considerable merit in the FCA being involved in decisions about whether publication of individual determinations is appropriate, taking into account the issue of whether the determination is consistent with FCA's own published rules and standards.

**31. What are your views on the proposed arrangements for strengthened accountability for the FSCS, FOS and CFEB?**

We agree that there should be a statutory duty for the FSCS and FOS, as well as the CFEB, to publish an annual plan, and to consult on it as appropriate. The assurance which the National Audit Office will provide in ensuring that these three bodies are carrying out their functions in an efficient and economic way is also welcome.

**32. What are your views on the proposed arrangements for international coordination outlined above?**

As will be apparent from previous comments in this response, we believe that the engagement of the UK regulatory authorities with European and international issues, and with the European Supervisory Authorities, and other international regulators, supervisors and standard setters, is absolutely critical to the success of the UK's new regulatory architecture.

As the Consultation acknowledges, the UK's regulatory structure (particularly the conduct of business/prudential divide) does not map exactly onto the EU's structure for financial regulation which is organised around activities. These potential mismatches create risks, not least since the European Supervisory Authorities will play a considerably more proactive and interventionist role than the Level 3 Committees, not only in standard setting, but also through direct engagement with financial market participants in collecting information, and in direct interventions with national regulators. We feel that in some areas the Consultation may not have fully taken into account the importance and extent of their new role, and the potential for regulatory duplication, inconsistency and overlap between European and UK regulatory initiatives.

As we have indicated above, firms are concerned about how the proposed UK specific arrangements be aligned to the European Supervisory Authorities, to regulators in other EU member states, and the various supervisory colleges. It is not clear what arrangements are

currently proposed for engagement with the individual FSB colleges; it seems to us that the PRA, rather than the Bank, is likely to be the most appropriate UK regulatory representative.

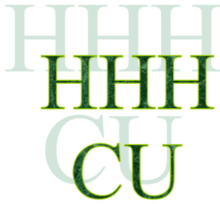
In terms of IOSCO representation, we would envisage that the FCA would have a more significant role to play than the PRA, and that it should retain the seat currently held by the FSA. We are, however, aware that significant work with prudential implications is currently being undertaken in IOSCO, and we accept that the FSA and the Bank are best placed to consider how seats should be allocated, and seat transitions managed.

We are strongly supportive of the proposal to legislate for a statutory MoU between the Treasury, Bank of England, PRA and FCA on overall international coordination within the UK system, covering engagement at the European level as well as with the wider international community.

In conclusion, we have very much welcomed the Treasury's willingness to engage with practitioners and industry during the consultation period. We also support the proposal for full public consultation on the detailed practical arrangements relating to the proposed philosophy and operating models for the authorities, which we believe will be critical in ensuring market confidence in the new regulatory arrangements. We would be happy to discuss any of our observations or suggestions with you further if this would be of assistance.

Yours faithfully

**Herbert Smith LLP**



Reg. No. 352c

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Tel: 01706 215082

**HHH Credit Union Ltd response to - HM Treasury CM 8012: A new approach to financial regulations – Building a Stronger System**

*Background*

*HHH Credit Union Ltd was established in August 1994 as a community-based financial co-operative. Its membership is 'live or work' with a common bond covering the old borough of Haslingden, Rossendale and the Borough of Hyndburn, East Lancashire. The area has a population of around 100,000 and covers four of the most deprived wards in North West.*

*The Credit Union has been actively involved with the delivery of the DWP Growth Fund, and now its successor initiative – the DWP modernisation and development fund feasibility study.*

*On behalf of our members, the Board wish to make the following responses:*

**Box 2.D: Consultation question**

1. What are your views on the likely effectiveness and impact of these instruments as macro-prudential tools?
2. Are there any other potential macro-prudential tools which you believe the interim FPC and the Government should consider?

*It is difficult to evaluate whether the tools set out in the consultation document, that the FPC can take to prevent a future systemic failure, are sufficiently robust to prevent such failure and whether this level of supervision will place too severe limitations on the everyday operations of financial institutions. From the point of credit unions, the systemic risks that may arise are relatively small, but the costs of funding an extra regulatory authority will be a major concern.*

**Box 2.F: Consultation question**

3. Do you have any general comments on the proposed role, governance and accountability mechanisms of the FPC?

*The proposals in terms of the composition of the FPC, particularly the inclusion of non-bank members to bring in expertise and knowledge from other fields, seem to be appropriate. There is some concern about how transparent the FPC can be in balancing the information it gives to the public whilst guarding against giving information that may give rise to alarm. The consultation document seems to imply that information which is held back will eventually be released, but it is not clear how the aim to be transparent will work in practice.*

**Box 2.G: Consultation question**

4. Do you have any comments on the proposals for the regulation of systemically important infrastructure?

*The sharing of information and co-ordination between the three authorities will be key to the effectiveness of the new system. It is helpful that the consultation document has set out its views on how this will operate in practice. This could be its strength, but may not be sufficient if roles become blurred over time, or has to deal with a large scale problem in the future, where there is serious banking*

*problem and the FPC has to challenge the financial institutions in a crisis situation. From the credit unions' point of view it is helpful to have a clear proposal that the PRA will have sole responsibility for the regulations (CREDS).*

*We take the view that one authority should be responsible for authorisation and removal of permission. We are concerned that if this role is spread across two authorities, it would lead to duplication of work, the possibility of conflicting opinions, confusion for firms and extra costs.*

**Box 3.C: Consultation question**

5. What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the PRA?

*Whilst we recognise the need for regulations, the majority are medium to small in size and can find some of the regulations overly bureaucratic and sometimes difficult to meet. Credit unions such as ours usually have few if any employed staff and are largely reliant on volunteers. Our experience is that volunteers are sometimes dissuaded to serve as directors because of the regulations. It is important for the regulators to ensure that the regulations are proportionate and appropriate to the size and complexity of the credit union.*

**Box 3.D: Consultation question**

6. What are your views on the scope proposed for the PRA, including Lloyd's, and the allocation mechanism and procedural safeguards for firms conducting the 'dealing in investments as principal' regulated activity?

*No comment*

**Box 3.E: Consultation question**

7. What are your views on the mechanisms proposed to make the regulator judgement-led, particularly regarding: rule-making; authorisation; approved persons; and enforcement (including hearing appeals against some decisions on a more limited grounds for appeal)?

*Our response to Question 5 is relevant to this question also. Whilst we recognise that credit unions are deposit takers and must take responsibility for all that this implies there is very little comparison between a bank and a small credit union with a few hundred members. There must be flexibility in how the rules are applied to credit unions to ensure that they are being managed responsibly, whilst recognising their inherent limitations.*

**Box 3.F: Consultation question**

8. What are your views on the proposed governance framework for the PRA and its relationship with the Bank of England?

*The explanation as to the separateness of the PRA seems to resolve the queries that were raised by others previously.*

**Box 3.G: Consultation question**

9. What are your views on the accountability mechanisms proposed for the PRA?

*The mechanisms in FSMA and the additional proposals set out in clauses 3.53 to 3.59 of this document would appear to ensure an appropriate level of accountability for the PRA.*

**Box 3.H: Consultation question**

10. What are your views on the Government's proposed mechanisms for the PRA's engagement with industry and the wider public?

*We are aware that the FSA has operated a good scheme of consultation, and that it has two key standing consumer panels for large and small businesses which have been very useful as a way of conveying the views of firms to the FSA and influencing decision making.*
*Consultation is very important as firms subject to regulation and the wider public have much to contribute and it is good to know that consultation measures will continue on much the same basis.*

**Box 4.B: Consultation Question**

11. What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the FCA?

*We welcome the reforms and the decision to intervene at an earlier stage regarding products.*

**Box 4.D: Consultation questions**

12. What are your views on the Government's proposed arrangements for governance and accountability of the FCA?

*The FCA will have a number of functions – engaging more directly with customers and promoting confidence in the financial services; dealing with financial crime; investigating and reporting on regulatory failure; regulating wholesale markets; sharing duel regulation with the PRA for firms outside their remit. Whilst at one level these can be seen as part of the protection of service to the customers, these roles are very different and pressures and high demand in one area may be disadvantageous to another. For example, promoting business on the one hand may conflict with investigating financial crime on the other. The plans for governance and accountability seem appropriate on paper, but the diversity of tasks may make these tasks more difficult in practice.*

**Box 4.F: Consultation question**

13. What are your views on the proposed new FCA product intervention power?

*Some powers will be welcomed to provide additional protection for consumers where there is limited protection at present. However, these are strong powers which could lead to serious repercussions for service providers (and perhaps for customers). It is therefore important that there is consultation about the circumstances in which these new product intervention powers will be used.*

**Box 4.G: Consultation question**

14. The Government would welcome specific comments on:

- the proposed approach to the FCA using transparency and disclosure as a regulatory tool;
- the proposed new power in relation to financial promotions; and
- the proposed new power in relation to warning notices.

*Whilst recognising the need to prevent detriment to customers, the possible threat of high fines greatly concerns credit unions as many are struggling to meet rising costs. A high fine that is appropriate for a large bank is not appropriate to a small credit union. Fines need to be more flexible and take into account the size of the firm and the level of services it provides.*

*In general, when judging the performance of credit unions, run largely by volunteers, it could be useful to look at some form of grading or grouping of credit unions that moves away from the current rather crude grading of Version 1 and Version 2, as this could help both regulatory staff and credit union directors to have a clearer understanding of how the regulations, policies etc should be applied to their situation.*

**Box 4.H: Consultation question**

15. Which, if any, of the additional new powers in relation to general competition law outlined above would be appropriate for the FCA? Are there any other powers the Government should consider?

*No comment*

**Box 4.I: Consultation question**

16. The Government would welcome specific comments on:

- the proposals for RIEs and Part XVIII of FSMA; and
- the proposals in relation to listing and primary market regulation.

*No comment*

**Box 5.A: Consultation question**

17. What are your views on the mechanisms and processes proposed to support effective coordination between the PRA and the FCA?

*Whilst the consultation paper has provided clarification about how co-ordination will take place between the two authorities, it is difficult to comment at this point until the MoU is published and we can see how this will operate in practice.*

**Box 5.B: Consultation question**

18. What are your views on the Government's proposal that the PRA should be able to veto an FCA taking actions that would be likely to lead to the disorderly failure of a firm or wider financial instability?

*In principle we agree with this proposal as the PRA is likely to have greater knowledge about a failing firm and may be able to assist that firm in improving its stability or in the case of credit unions, transferring its engagements to another credit union, or at least move to be being able to close down in an orderly way.*

**Box 5.C: Consultation questions**

19. What are your views on the proposed models for the authorisation process – which do you prefer, and why?

*We prefer the alternative approach where one authority (either the FCA or the PRA) are charged with the processing of applications for those firms for which it will be the regulating authority. This will avoid confusion for firms and ensure that a detailed knowledge of the firm making the application prior to registration will then be available to the authority responsible for on-going regulation.*

20. What are your views on the proposals on variation and removal of permissions?

*With regard to variation of permissions we feel that each authority should be responsible for deciding on the varying of permissions of firms it regulates and also that the present OIVoP and WoP arrangements should continue.*

*For credit unions it is vital that regulatory staff with sound knowledge and experience continue to be involved in authorisation and variation decisions, due to the special nature of these firms.*

**Box 5.D: Consultation question**

21. What are your views on the Government's proposals for the approved persons regime under the new regulatory architecture?

*We consider that duel decision making on approved persons is a recipe for delay in decision making, confusion for firms applying for approval and will lead to duplication and possible extra costs. We consider that one authority should be responsible for those firms it regulates, but obviously it could seek advice from the other where there are any concerns or grey areas.*

**Box 5.E: Consultation question**

22. What are your views on the Government's proposals on passporting?

*No comment*

**Box 5.F: Consultation question**

23. What are your views on the Government's proposals on the treatment of mutual organisations in the new regulatory architecture?

*HHHCU welcomes the inclusion of a section on mutuals and that it proposes to modify the consultation requirements for both the PRA and FCA regarding cost analyses and their effect on such firms.*

*Regarding the registration of credit unions, allocating registry powers to the prudential regulator seems sensible.*

**Box 5.G: Consultation question**

24. What are your views on the process and powers proposed for making and waiving rules?

*At what point will consultation take place with firms about proposed new rules or changes to rules? It could be helpful to firms to be aware of any disagreement between the authorities when responding to proposals.*

*As for approved persons, the waiver of rules should be made by the regulating authority, with consultation between the two authorities' only taking place where there is an issue of concern, to avoid duplication and confusion.*

**Box 5.H: Consultation question**

25. The Government would welcome specific comments on
    - proposals to support effective group supervision by the new authorities – including the new power of direction; and
    - proposals to introduce a new power of direction over unregulated parent entities in certain circumstances?

*No comment*

**Box 5.I: Consultation questions**

26. What are your views on proposals for the new authorities' powers and coordination requirements attached to change of control applications and Part VII transfers?

*No comment*

**Box 5.J: Consultation question**

27. What are your views on the Government's proposals for the new regulatory authorities' powers and roles in insolvency proceedings**?**

*No comment*

**Box 5.K: Consultation question**

28. What are your views on the Government's proposals for the new authorities' powers in respect of fees and levies?

*HHHCU believes that it is vital that the annual fee structure relating to credit unions continues to be based on the same formula as agreed with the banks and building societies and also continues to take into account their size and ability to pay. As indicated in our earlier response, the majority of credit unions are small/medium in size and some struggling to survive are faced with large increases in fees for*

*insurance, technology, auditing, accommodation costs in addition to the annual fees paid to the FSA including FOS and FSCS.*

**Box 6.A: Consultation question**

29. What are your views on the proposed operating model, coordination arrangements and governance for the FSCS?

*The proposed arrangements appear to satisfy concerns raised by others by setting out which authority will be responsible for particular rules/functions of the FSCS.*

**Box 6.B: Consultation questions**

30. What are your views on the proposals relating to the FOS, particularly in relation to transparency?

*We consider it would be appropriate for the FCA to take on the functions of the FSA. Transparency is important. The FOS newsletter, in particular, is very useful to practitioners in understanding how the FOS assesses and resolves complaints.*

**Box 6.C: Consultation question**

31. What are your views on the proposed arrangements for strengthened accountability for the FSCS, FOS and CFEB?

*We consider an audit by the NAO would strengthen their accountability.*

**Box 7.C: Consultation question**

32. What are your views on the proposed arrangements for international coordination outlined above?

*No comment*

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Dear Sirs,

In continuation of my response to your 1st consultation round July/August 2010 I would against take the change to comment on the second consultation paper.
Apologies for being slightly late as high work load did not allow for an earlier response.

As mentioned before I am an individual who has been involved in a wide range of bank charges refund claims over the last few years and as such have had regular contacts with the FOS in particular why my prime interest in this consultation is and has been the area of customer protection. Equally as before I copy my local MP Alan Reid on this as discussion with him on the matter originally pointed me to this consultation.

1. First of all I would like to welcome the final title FCA for the new body mostly concerned with customer protection as indeed conduct is at the heart of the issues long since troubling the sector. The paper mentions successful past FSCS interventions, the ongoing banking fees issues would be another. It is quite obvious that financial firms have decided on a kind of conduct unknown in other industries partly due to lack of customer protection but also lack of competition.

2. The proposed FCA regard for completion hence equally has to be highly welcomed as currently true competition is widely missing in the UK financial sector.

3. The same goes for the proposal to enable the FCA to conduct issue based in addition to firm based supervision as currently this is on the whole absent. Any kind of industry-wide supervision of terms etc. is long overdue.

4. Furthermore I clearly would like to welcome that the proposals on the FCA now clearly include its ability to impose redress for past misconduct which given that the aforesaid has been present in UK for many years is a hugely important matter of customer protection. Large numbers of customers have incurred significant losses and even hardship for years as a result of - in particular retail – banks' conduct and the lack of protection.

5. The paper rightly talks about customers' responsibility for their financial conduct. Too often in the past this has been used and abused as a excuse by financial firms when indeed only the aforesaid will enable customers to such after in the past often getting tangle in the net of the banks' conduct. I would expect the FCA to consider this link to make a future difference to that equation.

6. While I accept the remarks regarding bias of the term "customer champion" the importance to eventually establish a strong customer protection function can't be stressed enough. While financial firms have extensive lobby, legal and financial resources to protect their interests, in particular retail customers currently have neither. The proposals appear to recognise this with respective regards and objective for the FCA and as such are welcome.

7. On the same grounds a more formalised relationship between FAC and FOS is welcome and should indeed ensure the impartiality of the FOS which from a customer perspective recently appears to fade (see below).

8. The banking fees subject is an excellent example for the just made comments:
    a. To the best of my knowledge there is not a single bank in UK not having such fees regime, i.e. in the absence of any alternative customers are at the banks hands. This includes foreign banks operating here. This is all the more interesting as the same UK and foreign banks don't run similar regimes in other EU countries – clearly because competition and conduct regulators won't allow for that to happen.

b. While in the light of the OFT's "test case" in particular those banks involved in some areas somewhat lowered fees as they quite obviously were aware of their inappropriateness, fees now rise again widely in well disguised ways. Example: RBS has recently replace the one off over limit fee of £35 by a fee of £6 which is applied each day for up to 10 days per months that an account is over limit. While nicely presented as a reduction it not really will be for the majority of customers incurring such situation in the first place!

c. While on the whole record numbers of complaints are reported and in other areas are upheld, the FOS unlike before now simply points to the bank's terms and refuses to proceed complaints any further with rather templated reply letter. From a customer view this doesn't really present the FOS as impartial and at the same time there is presently no way to challenge those terms or press the banks otherwise.

As before I hope these comments are helpful as a response out of the general public and I look forward to the next steps in the consultation process.

Regards
Martin Holzke

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Dear Sir/ Madam

**A new approach to financial regulation: consultation questions**

Homeserve Membership Limited (HML) is a large insurance intermediary which falls within the general insurance intermediation category for regulation purposes. We understand that HML is likely to be solely regulated by the Financial Conduct Authority (FCA) as it does not fall into a category of firm which requires significant prudential regulation.

Further to your request for feedback on your proposals for the future of regulation I offer the following comments on behalf of HML.

**Section 5 Regulatory processes and coordination**

**Box 5.K**

**28 What are your views on the Government's proposals for the new authorities' powers in respect of fees and levies?**

In recent years the intermediary sector and their relevant trade associations have raised legitimate concerns with regards to the fairness of current funding structures. A promised review into how fees are levied was cancelled by the FSA in light of the proposed new approach to regulation.

Although you refer to the regulatory principle of 'proportionality' being retained by the FCA it is our concern that the current fee raising processes are in fact 'disproportionate', and require more than simply retaining the principle. We are therefore disappointed that the latest paper does not at least recognise these specific concerns.

An underlying principle should be that where a particular market failure has occurred, the source of any significant costs or compensation required should be tracked back to those firms who participated in that market; rather than the current blunt approach of firms having to contribute to costs or compensation merely because they are in the same general category as the failed firms.

We believe the opportunity should be taken to utilise the large body of evidence gathered by the FSA, FOS and the FSCS in performing their respective roles of the causes and main contributors to market failure. The intelligence should be used to refine risk models and apportion the costs of market failures more fairly.

Our views on a fair and proportionate funding structure are as follows:

- A funding model should recognise the principle that it is unfair for firms to contribute to the cost of regulating business for which they are not involved. The current method of implementing fee blocks for each type of business activity only partly addresses this requirement.

- A further distinction should be made, at a level below that of a business activity fee block, between firms that carried out high impact risk activities and those that carried out low impact risk activities. These comments apply equally to the funding models for the FCA, the FOS and the FSCS.

  For general insurance intermediation in particular, such a distinction was significant enough to merit substantial changes to the FSA's Insurance Conduct of Business rules with insurance differentiated between high risk/ impact 'protection products' and lower risk/ impact 'other' products. The split reflects the greater regulatory and supervisory burden associated with protection products although this is not reflected within the current funding model.

- Both FOS and FSCS have confirmed that the main driver of their recent and future costs, and thus a substantial increase in recent and proposed regulatory fees, is the result of PPI activity. A two-tiered structure for general insurance intermediation that takes PPI sales activity into account would therefore create a much fairer funding model allowing more accurate targeting against those firms that participated and profited most from this activity.

  Tier 1 general insurance intermediation fees would be based on the expected overheads from non-PPI complaints or compensation claims, and levied across all firms within the general insurance intermediation class in proportion to firm size;

Tier 2 general insurance intermediation fees would be based on the estimated costs arising from PPI complaints or compensation claims and would only be levied on firms that have generated an income generated from such activities, predominantly credit brokers. In recognition that complaints or claims may relate to selling practices, since prohibited, that occurred some years previously, the methodology would consider total income generated from sales made since 14 January 2005 when insurance became regulated. We note that the Competition Commission, in their 'Market investigation into payment protection insurance' report, published 2009, concluded that the level of pure profit from PPI activity, to the tune of £1.4 billion in 2006 alone, was excessive. Significantly, they were also able to specifically identify those firms that had profited most.

Without a tiered fee structure that takes into account the activity of firms within the PPI market, those that were unexposed to this high risk market ('low impact' firms), and thus did not benefit from 'excessive profits', are unfairly cross-subsidising the fees of those firms that were ('high impact' firms). Such has been the adverse impact of PPI that a 'one size fits all' model has seen fees for all firms within the insurance intermediation fee block substantially inflated as the costs for dealing with the problem have been equally apportioned across all firms regardless of whether they contributed to the problem or not.

This cross subsidisation is disproportionately greater for large 'low impact' firms as their fees will invariably rise in proportion to their size.

- There is also an opportunity to fairly apportion PPI market failure costs across firms other than general insurance intermediaries, particularly where such firms have profited significantly from PPI activity and, in some cases, exacerbated the problem through their own actions or inactions. Examples include:

  Product Providers/ Underwriters – the failure of product providers, under the 'Responsibilities of Providers and Distributors for the Fair Treatment of Customers' rules, to review and act on appropriate MI, such as excessive penetration rates, exacerbated the problem of PPI selling failures as actions were not taken that could have minimised the risk and volume of mis-selling. This was clearly a regulatory breach.

  Some PPI policies included nil refund clauses in breach of the Unfair Terms in Consumer Contracts Regulations 1999. Notwithstanding poor sales practices, this too will have been key driver of complaints, adding further to costs of redress and compensation claims falling on intermediaries.

  The Competition Commission estimated that after deducting the costs of claims and other expenses, product providers received in excess of £340 million profit per year from PPI sales.

  Home Finance Providers – single premium PPI was mostly arranged at the point of sale of a loan where an often substantial premium would be added to the original loan amount. Notwithstanding the commercial benefits negotiated with the product provider for associating such policies with their loan offering, the lender also receives significant benefits from additional interest payments for the duration of the loan.

  PPI compensation costs fall on the distributor responsible for selling the policy and could include the interest charged on that proportion of the loan which paid for the policy. Any contribution by the lender tends to be discretional with full liability often falling on the intermediary alone. If an intermediary subsequently goes out of business the current FSCS funding rules mean that the proportion of the claim that relates to interest payments must be met in full by other general insurance intermediaries rather than the lenders who profited.

  Although the above comments focus on insurance intermediation activities, a comparable enhancement across other business activity fee blocks, which may also include products/ services that can be similarly categorised as high impact/ risk or low impact/ risk, is likely to address similar inequities within those blocks. For example, a distinction should be made between lenders that were heavily exposed to the self certification market and those that were not.

- Fee setting processes should be within the scope of any independent audit to ensure they are effective, efficient and fair.

Regards,

Stuart Austin
Compliance Department
Contact No. 01922 651030

**Response to Treasury Consultation Paper "A New Approach to Financial Regulation"**

**From: - John Howard, as an individual at Consumer- Insights** (www.consumer-insights.co.uk)

**Contact: -** johnhoward@consumer-insights.co.uk

**I am a former Chairman of the FSA's Consumer Panel and a former non-executive director of the Financial Ombudsman Service. I was appointed by the Economic Secretary to the Treasury, Mark Hoban, to be a Commissioner with the Independent Commission on Equitable Life Payments. I also now provide advice to financial firms, trade associations and regulators on the consumer perspective of financial services and treating customers fairly. I am a non executive director of National Counties Building Society but these responses are not those of the society nor are they endorsed by it.**

**Since the beginning of the financial crisis the FSA has become more proactive, intrusive and judgement based. This approach has been successful and it is entirely right that the new regulators continue this approach.**

**The division of the FSA's responsibilities between the PRA and the FCA must ensure no underlap or overlap and must not result in an increased administrative burden on firms. It must always be remembered that increased costs to the industry are inevitably passed through as a 'cost of doing business' to consumers.**

**My responses to the specific questions posed in the consultation document are as follows:-**

**Box 2.D:**
*1 What are your views on the likely effectiveness and impact of these instruments as macro-prudential tools?*
*2 Are there any other potential macro-prudential tools which you believe the interim FPC and the Government should consider?*

**The tools outlined are appropriate but will only be effective if the regulators have the will to use them. This is much easier in the bad times than the good. It has been proved in the past that when markets are rising it becomes increasingly difficult for regulators to dampen the enthusiasm. In fact market forces are likely to encourage some national regulators to relax their tough stance to give firms the opportunity to grab market share from overseas competitors. The effectiveness of the tools available will rely on the judgements of the FPC, the Bank of England and the PRA and their ability to resist calls for a more relaxed regime when markets in the UK and firms in other jurisdictions are racing ahead.**

**The regulators should also be able to introduce swiftly new tools to control over exuberance in the market place as the industry devises new products and techniques to exploit market conditions.**

**Box 2.F: Consultation question**
*3 Do you have any general comments on the proposed role, governance and accountability mechanisms of the FPC?*

**It would be desirable to have some informed representative of the consumer on this committee as the largest stakeholder group which will be affected by the deliberations of the FPC. It would therefore seem appropriate to have greater consumer representation and a vote for the Chief Executive of the FCA.**

**Box 2.G: Consultation question**
*4 Do you have any comments on the proposals for the regulation of systemically important infrastructure?*

**No comment**

**Box 3.B: Regulatory principles to be applied to both regulators**
*The regulatory principles applied to the PRA and FCA are:*

1. *The need to use the resources of each regulator in the most efficient and economic way;*

**Agreed**

*2. the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;*

**Agreed**

3. *the general principle that consumers should take responsibility for their decision when fully informed;*

**Even if a consumer is fully informed it does not mean that they understand. This is a fundamental problem with trying to ascribe to consumers responsibility for their decisions. Consumers can only have responsibility for their decisions if they fully understand what they are buying and it is impossible to know if a person fully understands. They may think they understand when in fact they don't; they may partially understand and misunderstand the most important point; or they may understand at one moment and not some time later.**

**The financial services industry has used the provision of information as a proxy for understanding but it is not really adequate. For this reason it is not appropriate to have a general principle that fully informed consumers should take responsibility for their decisions because even if they have been given all the information they may still not understand what they have purchased and should not be made liable if they lack real understanding.**

**This is why the Financial Ombudsman Service is such an important part of the system. The Ombudsman is charged with deciding if in all the circumstances**

**of the case the consumer understood sufficiently what they were purchasing. Please see later section on the FOS.**

*4. the responsibilities of the senior management of an authorised person in relation to compliance with requirements imposed by or under this Act*

**No Comment**

*5. the desirability in appropriate cases of each regulator making information relating to authorised persons or recognised investment exchanges available to the public, or requiring authorised persons to publish information, as a means of contributing to the advancement by each regulator of its strategic and operational objectives; and*

**Agreed**

*6. the principle that the regulators should exercise their functions as transparently as possible.*

**Agreed**

**Box 3.C: Consultation question**
*5 What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the PRA?*

**No Comment**

**Box 3.D: Consultation question**
*6 What are your views on the scope proposed for the PRA, including Lloyd's, and the allocation mechanism and procedural safeguards for firms conducting the 'dealing in investments as principal' regulated activity?*

**No Comment**

**Box 3.E: Consultation question**
*7 What are your views on the mechanisms proposed to make the regulator judgement-led, particularly regarding: rule-making; authorisation; approved persons; and enforcement (including hearing appeals against some decisions on a more limited grounds for appeal)?*

**The purposive approach appears novel and could be very valuable but is untested and it remains to be seen whether short statements of purpose in relation to the rules will be sufficient to take successful enforcement action.**

**Box 3.F: Consultation question**
*8 What are your views on the proposed governance framework for the PRA and its relationship with the Bank of England?*

**No Comment**

**Box 3.G: Consultation question**
*9 What are your views on the accountability mechanisms proposed for the PRA?*

**I do not think it is appropriate that a non executive director of the Court of the Bank of England should be the independent person who hears complaints about the PRA. Such a person would already be too closely involved with the oversight of the PRA and may have been involved in the appointment of executives at the PRA whose judgement is being challenged in the complaint.**

**Box 3.H: Consultation question**
*10 What are your views on the Government's proposed mechanisms for the PRA's engagement with industry and the wider public? Where the PRA believes that its decisions will have a material impact on consumers, it will be required to consult the FCA to take advantage of its expertise, as set out in Chapter 5.*

**The Consumer Panel which will be set up under the FCA should not have its remit restricted to the matters covered by the FCA but must be entitled to comment upon and make representations to all bodies within the regulatory architecture including the PRA, the FPA and the Bank of England. It should be for the Consumer Panel to decide what issues are of importance to consumers. The Consumer Panel should be entitled to ask for and receive information and advice from the PRA and should be entitled to meet with the Chief Executive and the Chairman of the PRA at least once per year each.**

**Box 4.B: Consultation Question**
*11 What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the FCA?*

**These are appropriate and I support the notion that "different consumers require different degrees of protection, depending on their capability and personal circumstances, the product they are buying, and the channel through which they are buying it." But I would refer to my earlier comment on consumer responsibility and point out again that consumers should not be held responsible if it is reasonable to say that, despite the information provided, they did not understand the product or service they were purchasing. The only exception to this being in execution only transactions when the consumer accepts that they are taking responsibility for understanding the product or service. This will align the FCA's view more closely to the Financial Ombudsman Service view of what is fair and help to avoid future conflicts of view about what is fair. (see comments later re FOS)**

**Box 4.D: Consultation question**
*12 What are your views on the Government's proposed arrangements for governance and accountability of the FCA?*

**These are appropriate**

**Box 4.F: Consultation question**
*13 What are your views on the proposed new FCA product intervention power?*

**This will be an important and valuable power which should enable the new regulator to intervene early to remove products from the marketplace which could cause consumer harm. It is appropriate that this power should be set out in more detail to provide some certainty to firms.**

**Bringing a new product to market can be a costly exercise in terms of development, marketing and advertising and I believe the FCA should consider providing qualified approval (not pre-approval) for products to provide firms with some certainty and encourage innovation.**

**Box 4.G: Consultation question**
*14 The Government would welcome specific comments on:*
- *the proposed approach to the FCA using transparency and disclosure as a regulatory tool;*
- *the proposed new power in relation to financial promotions; and*
- *the proposed new power in relation to warning notices.*

**These are all very valuable measures**

**Box 4.H: Consultation question**
*15 Which, if any, of the additional new powers in relation to general competition law outlined above would be appropriate for the FCA? Are there any other powers the Government should consider?*

**No Comment**

**Box 4.I: Consultation question**
*16 The Government would welcomes specific comments on:*
- *he proposals for RIEs and Part XVIII of FSMA; and*
- *the proposals in relation to listing and primary market regulation.*

**No Comment**

**Box 5.A: Consultation question**
*17 What are your views on the mechanisms and processes proposed to support effective coordination between the PRA and the FCA?*

**This is one of the areas which could pose the most problems for the new structure. There is potential conflict between what is best prudentially and what is best for consumers. For example the prudential regulator may impose tough requirements on lenders which limit or restrict their ability to lend which may have the effect of reducing the number of people able to purchase a property. It is difficult to see how disagreements between the two regulators can be avoided. Firms will also suffer the risk of increased regulatory burden resulting from information and supervisory requirements of the FCA and the PRA.**

**Box 5.B: Consultation question**
*18 What are your views on the Government's proposal that the PRA should be able to veto an FCA taking actions that would be likely to lead to the disorderly failure of a firm or wider financial instability?*

**Box 5.C: Consultation questions**
*19 What are your views on the proposed models for the authorisation process – which do you prefer, and why?*
*20 What are your views on the proposals on variation and removal of permissions?*

**Box 5.D: Consultation question**
*21 What are your views on the Government's proposals for the approved persons regime under the new regulatory architecture?*

**No Comment**

**Box 5.E: Consultation question**
*22 What are your views on the Government's proposals on passporting?*

**No Comment**

**Box 5.F: Consultation question**
*23 What are your views on the Government's proposals on the treatment of mutual organisations in the new regulatory architecture?*

**No Comment**

**Box 5.G: Consultation question**
*24 What are your views on the process and powers proposed for making and waiving rules?*

**No Comment**

**Box 5.H: Consultation question**
*25 The Government would welcome specific comments on*

- *proposals to support effective group supervision by the new authorities – including the new power of direction; and*
- *proposals to introduce a new power of direction over unregulated parent entities in certain circumstances?*

**No Comment**

**Box 5.I: Consultation questions**
*26 What are your views on proposals for the new authorities' powers and coordination requirements attached to change of control applications and Part VII transfers?*

**No Comment**

**Box 5.J: Consultation question**
*27 What are your views on the Government's proposals for the new regulatory authorities' powers and roles in insolvency proceedings?*

**No Comment**

**Box 5.K: Consultation question**
*28 What are your views on the Government's proposals for the new authorities' powers in respect of fees and levies?*

**No Comment**

**Box 6.A: Consultation question**
*29 What are your views on the proposed operating model, coordination arrangements and governance for the FSCS?*

**No Comment**

**Box 6.B: Consultation questions**
*30 What are your views on the proposals relating to the FOS, particularly in relation to transparency?*

**The duty placed upon the FOS is to decide cases referred to it on the basis of what is fair "in all the circumstances of the case". Most consumer complaints are based on asymmetry of information between the financial firm and the consumer, and more importantly on the level of understanding the consumer has about what they have bought. A firm may follow to the letter the regulations for the sale of a particular product and judge that it has done all that is reasonable to enable a particular consumer to understand what they are buying. However it cannot be certain that a particular consumer in their specific circumstances has understood what they have bought. It is in this situation that the FOS has the power to ignore the law and the regulations and come to a decision that, in the particular circumstances of that case, and in that case alone, it was not reasonable to assume that the consumer had sufficient knowledge of what they were buying to make the transaction fair. This is a fundamental principle that must be preserved.**

**If a transaction is deemed unfair because of the nature or capability of the consumer then the FOS is entitled to ignore the existing rules and regulations to find in favour of the consumer. If the FOS decides that the unfairness lay in the product or the process then that is a systemic issue which it is the responsibility of the regulator to address.**

**If the FOS is making decisions about a significant number of cases with the same facts, it will usually have identified a problem with a particular product or sales process. There should be a trigger number of cases with identical facts which requires the FOS to involve the regulator as set out below.**

**If the FOS finds that a product or process is not fulfilling the regulators requirements it must notify the regulator and the regulator should be required to take up those cases and, using its enforcement powers, order compensation for the affected consumers and approve changes to the product or process before their continued sale.**

**If the product or process is fulfilling the regulators requirements but the Ombudsman is still of the opinion that in the majority of cases an unfair outcome is being produced it must again hand those cases to the regulator who must address the issue and make a ruling. The Ombudsman should not rule on those cases because it will in effect be acting as a regulator.**

**This could however create a point of conflict between the regulator and the ombudsman, which has occurred in the past with PPI. The FOS may decide that a systemic issue is creating unfair outcomes for consumers and refer it to the regulator. The regulator may in turn decide that, on balance, the systemic issue is not producing unfair outcomes for consumers. However as presently constituted the FOS could continue to find the practice unfair.**

**Any MOU between the FCA and the FOS must therefore contain a mechanism whereby a decision on fairness about a systemic issue identified by the ombudsman is agreed between the regulator and the ombudsman and the ombudsman must sign up to that interpretation.**

**It is entirely appropriate that the FOS publishes details of its determinations. These should not carry any details which might identify the consumer who has made the complaint. The FOS should also explain whether it regards the decision as turning on the particular facts of that individual case or whether there are likely to be many similar cases. As described above, if the ombudsman believes there could be many similar cases the FCA should be obliged to take regulatory action to deal with these cases.**

**Box 6.C: Consultation question**
*31 What are your views on the proposed arrangements for strengthened accountability for the FSCS, FOS and CFEB?*

**It is appropriate for all three bodies to be regularly reviewed by the NAO. To counter the effect of too many complaints being referred to the FOS the NAO should specifically undertake, in its regular review, an assessment as to whether firms should be settling far more of these complaints and whether the FCA should be doing more to ensure that they do.**

HSBC

HSBC welcomes HM Treasury's second consultation document, **"A new approach to financial regulation: building a stronger system"**. This response offers HSBC's commentary on the specific sections of the consultation document as follows:


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## CHAPTER 2

**1 What are your views on the likely effectiveness and impact of these instruments as macro-prudential tools?**

***General Comments***

**The role of credit supply.** In a speech at Columbia University in November 2010, Andrew Haldane of the Bank of England commented that “Credit lies at the heart of crises”. Avoiding crises requires a regulatory system that prevents credit expansion reaching unstable levels.

High, fixed capital ratios, strengthened liquidity requirements or other constraints on the regulated sector will not necessarily prevent unstable levels of credit expansion being generated elsewhere in the economy – in fact, at times of gathering economic momentum, such measures will *ensure* that credit intermediation is undertaken elsewhere. It is therefore imperative to avoid building a regulatory system which drives credit intermediation outside the regulated area, and then attempts to catch up by extending the regulatory perimeter. Long term stability requires that the regulated sector remains the principal engine of credit intermediation. This can be achieved simply by ensuring that banks are required to hold adequate but not excessive capital.

This means getting the framework right. We believe that HM Treasury’s proposals can achieve this but it will be crucial that the FPC is conceived as a vehicle to manage the supply of credit, thereby achieving financial stability, and not the other way round. Credit supply – the rate of credit intermediation – can be regulated by varying the ratio of capital banks are required to hold against different types of lending. A low ratio increases lending capacity, and if the concomitant funding is available, increases supply; a high ratio reduces lending capacity for a given level of capital.

Calibration of appropriate capital levels must be based on an assessment of risk – i.e. the likelihood and quantum of losses – which should be measured as objectively as possible. Without risk as the criterion, capital requirements could be subject to political interference aimed at fostering or choking off selected sectors of the economy. And, as will be explored below, the ability to explain policy changes because of perceived changes in risk levels will be crucial to winning public acceptance of the decisions of the FPC. Such explanations will also reinforce the FPC’s effectiveness in signalling trouble. Investors attracted by high returns offered by shadow banking activities might be given pause for thought if the FPC had already publicly identified the assets at the heart of those activities as increasing in risk. Once properly risk-adjusted, those returns might look less attractive.

**Minimising constraints on the operation of macroprudential policy.** The December 2010 Financial Stability Report of the Bank of England commented:

> *"It is important that CRD4 provides sufficient flexibility for national policymakers (such as the FPC) to adjust regulatory requirements to achieve macroprudential objectives. Maximum harmonisation of Basel III standards across the European Union would limit policymakers' ability to vary regulatory requirements countercyclically to reduce the build-up of risk. Cycles in credit are currently not closely synchronised across European countries and experience from previous financial crises reveals significant differences in the magnitude of losses incurred by banks when a period of exuberance unwinds."*

As stated above, we are not convinced that high fixed capital ratios guarantee financial stability. For this reason, we wholly support the Bank's comment and would request HM Treasury to take account of it when the Council considers the draft of CRD4. This flexibility should include the ability of the FPC to allow core tier 1 capital ratios to fall below 7% without penalty if warranted by the absence of risk, and the desirability of increased lending to foster economic recovery.

**Priorities.** HSBC believes it should be made clear that the risks inherent in the oversupply of credit should be as much a priority as the structural features of financial markets. It should also be a priority for the FPC to ensure that credit intermediation remains within the regulated sector, rather than allowing policy decisions which could drive credit intermediation outside the regulated sector, thereby setting off a possibly futile attempt to pursue credit intermediation activities by extending the regulatory perimeter.

**UK economy.** HSBC notes that the requirement to take account of the growth of the UK economy is voiced in the negative. We would prefer to see a formulation to the effect that the FPC should aim to preserve not just the financial system, but its ability to intermediate credit at a sufficient rate to sustain planned growth of the economy. The reason for avoiding financial crises is partly to ensure that taxpayer funds are not used to bail out failed banks, but more importantly that taxpayers do not suffer the far greater damage to their interests posed by the threat of a sudden contraction of credit supply to the economy.

### *Macroprudential tools*

**Generic and specific tools.** Generic tools are probably not good for managing specific risks. Risks tend to be driven not by the broad level of credit supply relative to GDP (as envisaged in the Basel counter-cyclical capital buffer) or, for example, the overall leverage ratio for any firm, although these factors can be helpful indicators. The potential for losses to materialise is more likely to increase as a result of the channelling of mis-priced credit to create exposures to specific economic sectors and their related asset classes, or to

specific counterparties. The structures of those exposures, and the liability structures supporting those exposures, are also important factors.

Generic measures such as counter-cyclical buffers could actually accelerate the development of sector specific bubbles, because broad capital constraint could push firms to seek the returns in asset classes where their models have not recognised the growth of systemic risks. In short, excess capital could drive the mis-pricing of credit.

Specifically:

(i) **Counter-cyclical Capital Buffers.** A copy of our submission to the Basel Committee on this subject is attached. This explains why we believe the Basel proposal to be flawed, both for the reasons set out above, and because we find it difficult to envisage circumstances in which the counter-cyclical buffer would be released, as intended, when most needed, i.e. to increase lending capacity at a time of credit constraint.

(ii) **Variable Risk Weights**. We strongly support the use of variable risk weights as a mechanism for managing the flow of credit into the system. This should be sector by sector. Recent crises have demonstrated that the number of sectors which can be responsible for generating financial instability is relatively few, suggesting the task of monitoring and calibration is manageable. Risk weights will need to be calibrated as objectively as possible, recognising that increases may need to be significant to be effective. A practical mechanism for transmission of the increased risk weight is suggested in our answer to question 2, below.

(iii) **Leverage Limits.** Like generic capital buffers, changes in leverage limits could cause firms to manage their asset portfolios to maximise leverage capacity for transactions offering higher returns, creating a bias for higher risk and possible mis-pricing. We do, however, see a possible use for a leverage limit as an expression of a jurisdiction's risk appetite (see the answer to question 3, below).

(iv) **Forward-looking Loss Provisions.** To the extent that these provisions were attributable to specific assets, this may offer benefits. However, there are real dangers in a divergence between accounting and regulatory valuations.

(v) **Collateral Requirements.** We believe collateral requirements such as loan-to-value limits and additional margin approaches for specific asset classes and transactions can be effective supplements to risk weight variations. Such administrative measures have been successfully applied in jurisdictions such as Hong Kong, where they also signal the build-up of risk to market participants. However, there is a danger that administrative measures can move some types of transaction, such as

retail mortgages, to the unregulated sector, as individuals pursue investment in asset classes perceived as high growth.

(vi) **Information Disclosure.** A critical feature of effective macroprudential regulation will be the supply of information – in terms of indicators and data – to inform FPC decision making. HSBC has explored a number of aspects of this issue, from the general economic and credit indicators which already support the Bank of England's Financial Stability Reports to more specific risk and market indicators, some of which involve a new approach to the evaluation of market data. We would be happy to share this work with HM Treasury. Systems for the evaluation of such indicators and data will need to be objective, and robust when confronted by evidence of developing asset bubbles. These systems should help to facilitate systemic intervention by the FPC when required, but should also enable individual firms on an ongoing basis to comprehend risks emerging as a result of developments, for example, in underwriting criteria, and to supply supervisors with improved quality of disclosure.

(vii) **Stress Tests.** These can be a useful tool but it is important to recognise that firms cannot protect against each and every eventuality. Due consideration needs to be given to the ability of the firm to cope with pressures in specific sectors through, for example, the diversity of its business model or the structure of its assets and liabilities.

Overall, we believe the tools are comprehensive in scope and flexibility. Their effectiveness will depend on the adequacy of the data fed into the FPC members on which they will make their decisions, as covered in (vi) above. We welcome the capacity both to create ad-hoc tools to meet specific circumstances and to expand those institutions subject to PRA supervision based on risk assessment.

**2 Are there any other potential macro-prudential tools which you believe the interim FPC and the Government should consider?**

The list, together with the flexibility to add ad hoc tools, seems comprehensive. We would, however, like to offer a practical proposal for a mechanism for transmitting increased or reduced risk weights, as mentioned in (ii) above.

In our response to the earlier consultation paper, we advocated the use of Pillar II of Basel II as the medium by which the PRA would respond to an FPC guidance or directive to increase capital levels on exuberant asset classes by increasing risk weights at the systemic level. We still believe this to be the best tool, and change could be most transparently effected by amending the Basel II scaling factor – currently 1.06 for all asset classes – in respect of the particular asset class or classes demonstrating exuberance. Pillar II could, of course, have been used for this purpose before and during the crisis, in response to the clear warnings expressed in the Bank of England's Financial Stability Reports.

**3 Do you have any general comments on the proposed role, governance and accountability mechanisms of the FPC?**

The arrangements appear comprehensive and suitably transparent. We welcome the clear linkages with the other arms of financial and monetary policy regulation and support the authority within paragraphs 2.89-2.97 to be flexible in the use of consultation depending on circumstances ahead of implementation of a macro-prudential tool. This flexibility however requires a great deal of trust in the members of the FPC, in particular the independent members, and we recognise the real world challenge inherent in securing the services of suitably experienced individuals who are not conflicted.

There is a school of thought that the Financial Policy Committee will be ineffective because its decisions could face public or political dissent, the anticipation of which would cause it to restrain its response.

There is a valid comparison here with the Monetary Policy Committee. The decisions of the MPC directly and personally affect every borrower. People now accept these decisions because they acknowledge, whether consciously or subconsciously, the importance of price stability. But at the inception of monetarist policy, it was by no means obvious that an unelected, technocratic body could wield such power without public dissent. The MPC does so because it operates within a very clear and simple statutory framework, and because it has a very clear target: to keep inflation within a set band either side of 2%.

It was argued above that objective calibration of risk as the driver for determining capital requirements would help avoid political interference. The same principle could help avert public or political dissent. A clear and simple statutory framework, to match that for monetary policy, could be as follows: **the central task of the FPC should be to assess the level of risk in the financial system and decide whether the system contains sufficient but not excessive capital relative to that risk and the supply of credit underlying that risk.**

This approach would also ensure that the FPC's attitude to the use of macroprudential tools would be symmetrical, i.e. that it would look to lower capital requirements at times of reduced risk, and raise them to track increased risk in exuberant asset classes.

This would be a more effective means of injecting capital into the system at times of increasing risk than the use of contingent instruments.

Against a clear and simple statutory framework, public acceptance of the role and decisions of the FPC might be achieved; and in time, public understanding of the importance of price stability might be matched by an understanding of the importance of stable supply of credit to the economy**.**

An additional question is whether the statutory framework for macroprudential policy could include a target to parallel that of monetary policy. HSBC contends that it could, on the following lines.

Businesses, particularly banks, have to determine their appetite for risk. Risk appetite is generally a Board decision, and the governance around determination of risk appetite is a crucial aspect of any private sector company. Accurately calibrated economic capital is the level of capital which matches the level of risk on a bank's books; the degree of capital a bank chooses to hold above its economic capital is determined by its risk appetite, which could be expressed either as a capital ratio or a leverage figure.

In the 21st Century, a government should also determine its appetite for risk. This could be expressed as the degree of leverage it would be willing to tolerate in a financial system within its jurisdiction, beyond which it would call for an injection of additional capital at the systemic level in order to bring leverage down. Such an expression of risk appetite could replace an arbitrary selection of a leverage ratio as a backstop, or an arbitrary determination that a financial sector within a given economy was "too big". The government's leverage limit could, in this way, delineate the parameters within which the FPC should operate. It is possible to envisage that over time, as in the case of the monetary target, empirical evidence could help identify an "optimum" level of leverage, with the FPC set a band either side of that level within which to steer macroprudential policy.

**4 Do you have any comments on the proposals for the regulation of systemically important infrastructure?**

We note that some elements of the proposals are preliminary, awaiting clarity on pending European legislation; we support the direction of travel set out in the consultation paper.

The FPC's role in the regulation of systemically important infrastructure will also be important in the context of the resolution framework, and will need to be taken into account when individual plans for the resolution of a firm are developed.

## CHAPTER 3

**5 What are your views on (i) the strategic and operational objectives and (ii) the regulatory principles proposed for the PRA?**

We welcome the emphasis given to the overriding importance of financial stability as a goal of the regulatory system and the context of placing the operational objective of promoting the safety and soundness of PRA authorised persons within that strategic objective.

We further welcome the clarity of the 'efficiency' and 'proportionality' principles.

While we agree that the 'responsibilities of senior management' principle properly holds senior management accountable for securing compliance with the regulatory framework, we wonder whether this could usefully be expanded to encompass the role of the Board in conducting oversight over senior executive management.

We agree with the view expressed that there should not be 'additional factors' to which the PRA and FCA should have regard beyond their primary objectives.

We also believe that the PRA's objectives should be framed in such a way as to give recognition to the potential economic consequences of supervisory intervention. For example, if banks were required to have extremely high capital ratios, this could have some marginal benefits for financial stability (although there are real dangers that this would actually increase risks in the financial system due to aggressive behaviours taken to maintain returns or the migration of activity to the unregulated sector). However, there is also little doubt that these would have an adverse economic consequence. The objectives could encompass an objective of creating the right balance to maintain the social utility of an industry which has been at the heart of Britain's economic and commercial strength over the last 300 years.

**6 What are your views on the scope proposed for the PRA, including Lloyd's, and the allocation mechanism and procedural safeguards for firms conducting 'dealing in investments as principal' regulated activity?**

We believe that it is essential that the regulation of the banking and insurance sector is co-ordinated - there are many interactions between firms that operate in each of these arenas as was seen in the financial crisis. Furthermore, the ongoing prudential regulation of each of the sectors will have implications for the other, for example, the Solvency 2 proposals will constrain insurance companies' ability to own long-dated bank debt which is capable of being bailed-in, but the bail-in regime is a critical part of the financial stability framework for banks.

It is also important that the PRA has the ability to extend its remit into additional areas. However, it is not clear that the limitation to 'dealing in investments as principal' is the right one. The essential element of banking which needs to be considered is maturity transformation where assets have natural durations (as opposed to contractual durations which may be subject to roll-overs or liquidity events) which are significantly longer than the expectations of the liabilities which have financed these. This is the critical element which induces financial instability, with forced short term asset sales to generate cash for repayments and/or demands placed upon other players in the financial system include central banks.

**7 What are your views on the mechanisms proposed to make the regulator judgement-led, particularly regarding: rule-making; authorisation; approved persons; and enforcement?**

We support the greater use of principles and welcome the proposed short statements that will explain the rationale behind the rules. It is important however that these rationales are not drawn so widely as to allow a retrospective interpretation of a rule that could not have been foreseen by market participants.

We welcome the ‘whole firm’ approach to authorisation and the focus on the viability of the business model and risk mitigation controls.

On enforcement we understand the need to protect a judgement based decision process through limiting grounds for appeals but repeat the earlier point that there has to be a safeguard against retrospective rule making through interpretation of principles.

We look forward to learning more on the detail of the operation of the proposed Proactive Intervention Framework; in principle this is an understandable process but we would want to understand the governance around its application and the transparency of firms being handled within the framework.

While fully supporting a judgement-led approach, we would add that:

(i) It is important that there is transparency about the underlying factors which have led to specific judgements so that firms and individuals have the scope to correct factual errors and present alternative views on situations. There may be cases where the relationships which are driving rule-making, for example, between capital and financial stability, are not necessarily as clear cut as the regulator may consider and due consideration should be given to alternative views. Furthermore, firms and individuals should be given the opportunity to propose alternative approaches to address issues where these are based upon judgements.

(ii) In an environment where judgement is critical, the experience, integrity and quality of the individuals exercising those judgements is essential.

That means putting in place a structure for employment and remuneration which encourages the best individuals to seek roles with the regulators, potentially as part of a career in both the private and public sectors.

We look forward to the consultation on the Proactive Intervention Framework in due course. We trust that this will be integrated with the EU Crisis Management framework and initiatives underway in other major jurisdictions (such as the US) to ensure that firms do not have to contend with multiple and conflicting legislative agendas.

**8 What are your views on the proposed governance framework for the PRA and its relationship with the Bank of England?**

We support the PRA being part of the Bank of England, see considerable benefits to delivering financial stability from the close relationship that is envisaged between the PRA and the rest of the Bank of England and believe the governance framework outlined is appropriate.

However there is a danger that the budget and structure of the PRA falls within the overall responsibility of the Bank of England and is required to fit within its framework. This may not give the PRA sufficient flexibility to recruit and retain individuals of the calibre required to operate a judgment-led approach.

**9 What are views on the accountability mechanisms proposed for the PRA?**

We support the proposed arrangements and in particular the new measure to make a report to the Treasury in the event of a significant regulatory failure. The framework has a good set of checks and balances which should ensure its effective operation. However, there are some areas which are of concern:

(i) Reports on regulatory failure may contain confidential information which is disclosed where that is considered to be 'in the public interest'. There is a real danger that there is pressure to disclose matters which are simply of interest to the public and not genuinely of importance to the matter in hand or future policy; it will be important to guard against this.

(ii) There is a suggestion that a non-executive director on the Court of the Bank of England could undertake scrutiny of complaints. This level of independence would not be considered sufficient in the case of many public companies where it is important that independence is seen to be the case, regardless of the integrity of the individuals concerned.

**10 What are your views on the Government's proposed mechanisms for the PRA's engagement with industry and the wider public?**

We support the focus on quality rather than quantity of regulation and the proportionality being envisaged for cost benefit analyses. We agree with the intention to disband the consumer panel and believe the interactions proposed between the PRA and the FCA should be sufficient. The transparency on assessment of the achievement of PRA objectives is welcomed.

## CHAPTER 4

**11 What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the FCA?**

*(i) Strategic and operational objectives*

We are broadly supportive of the proposed strategic and operational objectives. We welcome the fact that the FCA's strategic objective is focused on 'protecting and enhancing confidence in the UK financial system'. We believe that the proposal for the FCA to have a single, strategic objective complemented with a clear set of operational objectives is a better, more focused approach. This contrasts with the original proposal for the FCA to have one primary statutory objective, supplemented with a range of 'have regards' and 'wider public considerations' which would not have delivered the same level of clarity.

We agree that, in discharging its functions, the FCA should act in a way that is compatible with its strategic objective, but we believe that, in doing so, it should be required to advance more than one if its operational objectives. In addition, we believe that the FCA should be required to act in a way that does not inhibit the achievement of any of its operational objectives.

*Operational objectives*

We are supportive of the inclusion of 'facilitating efficiency and choice in the market for financial services' as an operational objective: this recognises the importance of competitive markets in delivering better choice and improved outcomes for customers. In addition, and as reflected in the existing FSMA principles of good regulation, we believe that the FCA's operational objectives should incorporate reference to 'maintaining the competitive position of the UK'. Maintaining competitiveness is vital to supporting and encouraging enterprise and is critical to the overall health of the UK financial services industry.

We are supportive of the objectives to 'secure an appropriate degree of protection for consumers' and 'protecting and enhancing the integrity of the UK financial system'. Establishing what is 'an appropriate degree of protection' will be a critical part of the FCA's operating model, and on which we expect the FSA to consult formally. It will require a flexible approach that affords different levels of protection depending on the nature of the customer, whether retail or professional market participants.

It is vital that an appropriate balance is struck between ensuring appropriate consumer protection, in particular, that consumers have access to appropriate products that meet their needs at a competitive price, and ensuring firms are able to make the profits they need to grow, develop, be sustainable, support the economy, and contribute to financial stability.

*(ii) Regulatory principles*

We are broadly supportive of the proposed new regulatory principles. In particular, we welcome the inclusion of the general principle that consumers should take responsibility for their decisions. We want to ensure the further development of a market in which customers are provided with an appropriate level of clear, understandable product information from which they can make informed decisions.

We believe that there must be appropriate balance in the FCA's regulatory approach and that the costs of regulatory action should not outweigh the benefits. We therefore support the principle that any burden or restriction which is imposed on a person, or carrying out of an activity, should be proportionate to the benefits.

We would welcome further clarity on the principle of the desirability of the PRA and FCA making information relating to authorised persons or recognised investment exchanges available to the public, or requiring authorised persons to publish information. The FCA's legislative framework must have appropriate safeguards to guard against inappropriate disclosure.

**12 What are your views on the Government's proposed arrangements for governance and accountability of the FCA?**

We welcome the fact that the statutory consultation requirements of the PRA will be equivalent to those of the FCA. Both will exercise quasi-legislative rule-making powers and, in doing so, must be subject to equivalent accountability requirements. In addition, we support the proposed new requirement for the FCA to make a report to HMT where there is a conduct regulation failure. This strengthens and formalises the line of accountability from the FCA to HMT.

We are supportive of the retention of the statutory panels, which provide essential external challenge to policy proposals and bring invaluable insight into the practical impacts, costs and benefits of those proposals.

In terms of governance arrangements, we believe that those of the Bank of England (including the UK resolution authority), PRA and FCA must be consistent with the UK Code on Corporate Governance.

**13 What are your views on the proposed new FCA product intervention power?**

We believe that it is essential that retail clients are appropriately protected against detrimental products and that firms have an appropriate level of certainty to undertake their business. We would expect that the circumstances in which the product intervention power would be exercised in relation to wholesale markets would be limited, particularly given the moves to central

clearing and increased transparency through European and US regulation. The FCA's power to make temporary product intervention rules must be subject to appropriate checks, including an established and documented process which is transparent to regulated firms. A balance must be struck between allowing the FCA to act quickly to protect clients from detrimental and exploitative products, and avoiding destabilisation, unintended consequences and risks for clients, corporate entities and the market (for example through inability to hedge commercial risk related to a banned product). The focus should be on identifying any issues as early as possible in the product cycle so as to maximise the efficacy and efficiency of any intervention and minimise possible losses or risks to the market and firms. A decision to intervene should be determined by the extent to which there has demonstrably been a failure on the part of a firm to take appropriate steps to mitigate a substantive risk arising from a product feature and it is reasonably foreseeable that the risk is likely to cause significant client detriment. Use of the power must also be balanced against the FCA's operational objective to facilitate efficiency and choice in the market for financial services.

Our main concerns are that:

- In the absence of appropriate, robust safeguards, the FCA's power to make temporary product intervention rules could have an adverse impact on product innovation and diversity, resulting in a lower risk appetite, and a lack of products that properly meet the range of client needs, particularly those of more sophisticated clients. Some clients may be exposed through an inability to hedge legitimate risk if the power is used too broadly or without consideration of all possible impacts.

- The FCA must make it clear that exercise of the intervention power may not be appropriate for all clients, in particular, the circumstances in which it is likely to be appropriate in relation to professional clients or eligible counterparties, will be different than those for retail clients, and for the latter clients, there will be varying levels of financial capability. A one-size fits all approach for retail and professional clients will not work. The paper notes that the FCA's role will include greater consideration of risks and issues across the 'financial value chain', including how they are 'transmitted between wholesale and retail markets' although limited detail is provided on how this will work in practice and how it fits with the general principle of proportionality.

- Firms must also have the ability to make representations to challenge FCA decisions to intervene (within short order) with a right of appeal. The FCA must also be required to formally consider the wider market impacts of any product ban.

We would welcome formalisation of the process requirements for intervention and we welcome the decision to consult on the principles that will govern the circumstances in which the power will be exercised. In framing those principles,

it will be critical that consideration is given to responses on the FSA's Discussion Paper on Product Intervention.

**14 The Government would welcome specific comments on:**

- **The proposed approach to the FCA using transparency and disclosure as a regulatory tool**

The paper conflates the issues of transparency and disclosure; these are distinct forms of information transmission which the FSA, and successor regulators, must consider separately. The principle of transparency is paramount, in our view, and should embed in the FCA a culture of routine openness that enhances customer trust in the financial system. Disclosure, as described in the proposals, is the practice of structuring limited data release for the purposes of encouraging or discouraging types of behaviour. It is an important tool for any regulator to have at its disposal but must be used only with regard to regulatory decision-making, not as a general implement.

We wholeheartedly support the principle for the FSA, and in future, the PRA and FCA to exercise their function as transparently as possible, making available information about their decision-making processes, minutes of critical meetings, including deliberations and evidence that informed decisions, and their emerging thinking. In addition, and to strengthen regulatory transparency, we believe that the practice of anonymising firms in regulatory statements must end. We believe that the FCA and PRA could each establish, as part of their internal governance arrangements, an appropriate executive committee to monitor transparency which, in turn, could be subject to external audit.

In terms of disclosure, it is absolutely critical that the broader context in which data is released by the FCA and PRA is properly explained and that there is a statutory requirement built into their respective legislative frameworks for disclosure to be fair to all parties, having regard to commercial sensitivities and confidentiality. Disclosures and notices on specific products and services should only be made where the FCA has concluded its formal investigations and firms have had the opportunity to make representations. We believe that framing the legislative safeguards so that they secure the right balance between the interests of consumers and firms will be critically important.

- **The proposed new power in relation to financial promotions**

We welcome the proposal to allow firms to make representations where the FCA considers that there has been a breach of its financial promotion rules and for the FCA to give written notice to the firm of its final decision and to publish details of the notice, where appropriate. We also welcome the proposed safeguards that will confer on firms a right of appeal to the Upper Tribunal.

- **The proposed new power in relation to warning notices**

The paper makes it clear that the FCA will publish the fact that an early enforcement warning notice has been issued (which signals the start of formal enforcement proceedings), unless doing so would be contrary to its strategic and operational objectives. We believe that the proposed new power poses major risks to firms which could suffer unjustified reputational damage before having had the opportunity to challenge the accuracy of the facts. Although the FCA will be required to publish a 'notice of discontinuance' where enforcement action is stopped, the reputational damage will, at that stage, be irreparable. There is also the added risk that the FCA may feel much stronger pressure to publish warning notices and then pursue enforcement cases if it has publicised a warning notice. We do not believe that the power to publish an early warning notice will 'enhance consumer and industry confidence in the new regulatory system', nor will it enable consumers to make more informed decisions.

While we welcome the proposed safeguards, in particular, that the regulator will have discretion as to whether it publishes warning notices, we are concerned that there is no capacity for firms to make representations challenging an FCA decision to publish an early warning notice.

**15 Which, if any, of the additional new powers in relation to general competition law outlined above would be appropriate for the FCA? Are there any other powers the Government should consider?**

We believe that any decision to afford new powers in relation to competition law to the FCA should form part of the existing BIS consultation on reform of the competition regime, otherwise there is a risk of a piece meal, disjointed approach to reform.

Under the existing competition regime, firms have the right to challenge decisions made by competition authorities by referral to the Competition Appeals Tribunal. We believe that it is critical that firms retain this right under the new arrangements.

**16 The Government would welcome specific comments on:**

- **The proposals for RIEs and Part XVIII of FSMA**
- **The proposals in relation to listing and primary market regulation**

We are broadly supportive for the RIEs proposals, and believe that the FCA should be responsible for their conduct and prudential arrangements. We do, however, have some concerns in relation to the amendments to Part XVII of FSMA.

While we support the extension of Section 166 powers to issuers, we would welcome further guidance on whether this will capture documents provided by

the sponsor and how legal privilege issues will be managed. We also support allowing the UKLA to discontinue or suspend a listing at the request of an issuer without following the warning and decision notice procedure. We believe that the issuer should be able to suspend its listing quickly where there is good reason for doing so. We believe that the FCA should have responsibility for determining whether to discontinue or suspend a listing at the request of an issuer.

In respect of the discontinuance of a listing without notice, however, we do not believe that cancellation without prior notice is in the interests of shareholders except, perhaps, in limited circumstances, such as a takeover or scheme of arrangement for which there are existing shareholder protection mechanisms in place.

We would welcome further clarity on the penalties (e.g. proposed level of fines, criteria for suspension/restriction of activities) that the UKLA will be able to impose. We do not believe that the UKLA is the right entity to assess financial damages – investors already have the ability to take action against an errant sponsor through the Courts.

## CHAPTER 5

**17 What are your views on the mechanisms and processes proposed to support effective coordination between PRA and FCA?**

We strongly support the proposed statutory duty for the FCA and PRA to coordinate and believe that this is critically important for dual regulated investment firms, particularly in terms of day-to-day supervision and enforcement. Indeed, we believe that this duty should extend, where appropriate, to co-ordination with the UK resolution authority. We believe that provision should be made in the legislative framework for a presumption that when a dual-regulated investment firm has informed one regulator of a particular matter, that all regulators (FCA, PRA, UK resolution authority) have been informed. Firms should, however, be able to request, for confidentiality reasons, that data is not shared between the regulators.

We would welcome the opportunity to comment on the Memoranda of Understanding to be drafted between the regulatory authorities. Supervisory coordination for dual regulated firms is key, particularly in relation to systems and controls (for example outsourcing notifications).

The paper suggests that the PRA will take a ‘proactive interventionist’ approach to create presumptions of regulatory action in certain circumstances and the FCA will take a more ‘preventative approach’, intervening earlier to prevent potential consumer detriment. Absent effective co-ordination, we believe that there is a risk that judgements to intervene will not be consistent or consistently well informed and that such judgements could restrict innovation and business growth.

## CHAPTER 6

**29 What are your views on the proposed operating model, coordination arrangements and governance for the FSCS?**

We are not against the proposed operating model, co-ordination arrangements, and governance for the FSCS. We support the proposal requiring the FSCS to put in place an MoU with both the FCA and PRA, and on which we expect the FSCS to consult.

**30 What are your views in the proposals relating to the FOS, particularly in relation to transparency?**

We strongly agree that the function and responsibilities of the FOS should be distinct from those of a regulator. When FSMA was consulted on in the late 90s, the view was that FOS would offer customers quick and effective resolution of individual complaints, as an alternative to the court process. The existence of an effective appeals mechanism was of limited importance because the intention was that the FOS would consider individual complaints. In the intervening period, however, FOS has mutated into a mass claims body, making decisions which go far beyond individual complaints, acting as a regulator without any attendant accountability mechanisms, check and balances on the exercise of its powers. CMCs have seized upon this to exploit the system and the way FOS operates in such cases.

We believe that the lack of an effective appeals mechanism for FOS decisions is a fatal flaw in its accountability. While it is open to firms to apply for a judicial review of the decision, this would only focus on the way in which the ombudsman had arrived at the decision, not the facts and merits of the dispute *i.e.* what the Ombudsman has decided constitutes a 'fair and reasonable' outcome. This is a wholly subjective assessment which varies depending on the particular Ombudsman who decides the case. In the absence of exceptional circumstances, the ability to judicially review FOS decisions is confined to a review of an individual decision making it very difficult to challenge a policy or course of behaviour. For this reason, we consider that the 'fair and reasonable' jurisdiction (Section 228(2) of FSMA) lies at the heart of the flaw in the system, particularly in the absence of an effective appeals mechanism.

We believe that there is an urgent need for an independent appeals mechanism. The appeals mechanism must be capable of determining what outcome is 'fair and reasonable in all the circumstances of the case' *(i.e.* the basis on which the FOS reaches decisions). One option could be for an appeals mechanism to be provided through the existing Upper Tribunal (which will be able to hear appeals in relation to the exercise of powers by the FSA in relation to consumer redress schemes*),* if it is specifically given the power to undertake a review of the facts and merits of the dispute *i.e.* the substance of the underlying issues, not simply the form of the decision. We consider that the

availability of an independent review of decisions on a merits basis in those cases where FOS decisions have much wider implications is imperative, particularly in the current complaints environment.

The fact we are currently in litigation with the FSA and FOS on PPI is a failure of the current system. Had firms been able to challenge the substance of FOS decisions through an effective appeals mechanism, this may have been avoided. While we accept that in the new regime, the FCA should be able to 'choke off' detriment before it occurs, there will still be a need for what are pre-eminently legal issues to be tested, whether that is by way of a challenge to a FOS decision, or an FCA sponsored consumer redress scheme.

We believe the proposed structural changes, of which the creation of the FCA forms part, provide an ideal opportunity to address this important issue, and to take much needed steps to improve the accountability of FOS decision-making. The fact that the new regulatory authorities will assume a more 'judgement-based' approach also makes an independent appeals mechanism all the more important.

**31 What are your views on the proposed arrangements for strengthened accountability for the FSCS, FOS and CFEB?**

We support the proposed arrangements for strengthened accountability for the FSCS and CFEB, but believe that the FOS requires much more fundamental reform (*See question 30 above).*

***Additional issues***

*Consumer redress*

We continue to have reservations about the FSA having power, and in future, the FCA, to put consumer redress schemes in motion when there is a significant difference of opinion on the legal position, rather than achieving legal clarity in advance of announcing a scheme. Experience with the new consumer redress arrangements will enable us to see whether it provides legal certainty more quickly than we have seen the past, which is in the interests of government, regulators, banks and their customers.

In this regard, however, we do continue to have fundamental reservations about the adequacy of the appeals process provided by the Upper Tribunal, given that its remit, and the matters to which it is permitted to have regard, are effectively limited to the grounds for a judicial review. Our preference would be for redress schemes proposed by the FSA to be subject to approval by the court or, at the least, for the Upper Tribunal to be permitted to assess appeals against the schemes on the underlying merits of the scheme itself.

*Supervisory approach/rules-based approach*

We have taken careful note of the deliberative shift in approach from rules to outcomes-based regulation. The challenge this presents for firms, however, is how they know, at the point the customer purchases a product, that it is a "good sale" or "good product", particularly in circumstances where the FSA has been briefed on, had the opportunity to comment on, even required forms to makes changes in products, but has stopped short of being prepared to approve products.

This approach impedes firms' ability to do business, creates unnecessary fear and uncertainty, hampers innovation, and will not encourage new entrants to the market.

## CHAPTER 7

**32 What are your views on the proposed arrangements for international coordination outlined above?**

We strongly support the statement in paragraph 7.5 “A clear lesson from the crisis is the need for greater international coordination and cross-border cooperation.” It is important that coordination and cooperation is reinforced at all levels from political agreements at G20 and EU level through implementation of new rules to day-to-day supervisory cooperation.

The G20 has provided much needed political leadership on the key issues that need to be addressed in the wake of the financial crisis – thanks in large part to the initiatives begun under the UK Presidency in 2009. However, there is increasing evidence that in implementing the broad principles called for by the G20, regional and national administrations are failing to coordinate the impact or timing of changes. This is leading to inconsistency and therefore potential conflicts of laws and uncertainty. Unchecked, such inconsistency may in turn lead to uneven outcomes, thereby undermining the G20 objectives. Examples of areas of current concern include bank resolution and clearing arrangements.

We therefore consider that stronger coordination of implementation efforts is required and would suggest that one way forward would be for the FSB to call on regional and national authorities to minimise any extraterritorial scope of their proposed legislation and provide an implementation framework to ensure a coordinated and consistent approach.

We recognise that the pace of regulatory change has accelerated considerably since the crisis, putting additional pressure on policymakers, regulators and industry to frame and respond to proposals and to implement the necessary reforms. We particularly value the continued engagement with the UK authorities on both EU and international policy development and rule-making. We also believe that the statutory framework for FSA rule-making – based on prior economic impact analysis and effective public consultation – leads to better regulation. We would urge therefore that the UK authorities should continue to encourage the wider adoption of such practices within Europe and internationally, including by the ESAs, and to avoid the risk that inadequate consultation could undermine the quality of regulatory outcomes.

We agree that, given the breadth and diversity of its financial markets, the UK authorities are well-placed to influence the EU and international regulatory debates, and welcome the commitment given in paragraph 7.9 to make international engagement an on-going priority. However, we would urge that such influence should always prioritise constructive dialogue over regulatory “front-running” (examples of the latter include the FSA’s liquidity standards and, going further back, the market abuse rules). Such practice can unhelpfully constrain the UK’s negotiating position (particularly when the industry has

already borne the adjustment costs) and may subsequently give rise to super-equivalence and an un-level playing field with other jurisdictions.

We welcome the involvement of the UK regulatory authorities in the ESAs and indeed the Governor of the Bank of England's deputy chairmanship of the ESRB. These bodies will be significantly more important than the committees which they replace; and, along with the rest of the industry, we will also seek to increase our engagement with these bodies. It is important that the high-level UK appointments that have been made are followed through to the wider staffing of these bodies.

More broadly, it is crucial that the relatively small budgets allocated to UK secondees to EU and international bodies are not sacrificed as the current spending cuts are worked through. Such secondees can play an important role in contributing knowledge and expertise in UK market practices and rules, particularly to those institutions that are drafting legislation, such as the European Commission, where the UK remains significantly underrepresented in the permanent staff. For its part, the industry is unlikely to object to the de minimis incremental cost in its supervisory fees resulting from such secondments from the UK regulatory authorities.

We agree that it is important that any coordination arrangements put in place by the UK regulatory authorities as regards engagement with the ESAs take fully into account the structural differences between the ESAs, which are organised on a sectoral basis, and the "twin peaks" structure of the future PRA and FCA. We consider that the measures set out in paragraphs 7.20-7.30 seem sensible insofar as they go; however, given that the Government (specifically HM Treasury) is ultimately responsible for UK policy in these areas, we would welcome stronger HM Treasury involvement in such coordination where appropriate.

Equally important is ensuring that issues do not fall between the individual ESAs and that the coordination mechanisms put in place between these bodies and with the FCA/PRA/UK resolution authority also work effectively. To facilitate such coordination we would welcome a "single point of contact" approach for communications between ESAs (or other international bodies) and the UK regulators.

**The Hundred Group**
of Finance Directors

**Investor Relations and Markets Committee**

Financial Regulation Strategy
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13 April 2011

Dear Madam / Sir

**A new approach to financial regulation: building a stronger system**

We are pleased to submit our comments on the above consultation.

**Who we are**

The Hundred Group is a non-political, not-for-profit organisation which represents the finance directors of the UK's largest companies, with membership drawn mainly, but not entirely, from the constituents of the FTSE100 Index. Our aim is to contribute positively to the development of UK and International policy and practice on matters that affect our businesses, including taxation, financial reporting, corporate governance and capital market regulation. Whilst this letter expresses the view of The Hundred Group of Finance Directors as a whole, they are not necessarily those of our individual members or their respective employers.

**Our views**

We made a number of comments in the course of our original submission and hence have decided to restrict our comments to just 2 critical and related issues.

***1. Attractiveness of the UK Market***
As set out in our original response, the Hundred Group is committed to supporting the competitiveness of the UK as a respected, global financial centre.

Underpinning UK competitiveness is the strength of our capital markets and their integrity, commerciality and stability. The Government's desire to 'see a competitive, world-leading financial services industry in the UK', which assumes that this will arise from 'a rigorous and effective regulatory framework which provides a strong platform for sustainable growth and success' would appear, to us, to be over-simplistic. Inappropriate or overly burdensome regulation may assist stability, but may also restrict available resources, which would not contribute to growth.

We note that the recent interim report from the Independent Banking Commission specifically examines the impact of the proposed reforms on the attractiveness of the UK as a place to locate international financial services activity. We consider that, in the same way, it would be extremely short sighted to design a regulatory architecture which does not need to similarly

reflect on the impact of their proposals. We would therefore like at least one arm of the proposed regulatory structure to be mandated to consider the impact of any regulatory proposals on the attractiveness of the UK economy, to both UK based institutions and overseas investors.

***2. Cooperation and collaboration***

In order to operate effectively within its remit and to deliver the operational benefits of the new structure, there must be full and unfettered cooperation and collaboration between the PRA, the FCA, and the Bank of England.

While we support the statutory duty to coordinate, this culture will be better ingrained if supported at the highest level. To this end, we fully support cross-membership of the boards. In addition we would recommend the establishment of regular, minuted meetings held between the bodies, attended and reviewed by government, as well as clear accountability within government for ensuring that trends across markets are highlighted and understood. This should provide the government with ample warning of growing concerns across markets, as well as an understanding of risk if action is not forthcoming

Coordination between the different bodies is equally important when considering the need to interact positively and constructively in Europe and Internationally. We anticipate that policy and legislative developments in Europe will have an increasingly significant impact on the UK in the coming years, which will require a correspondingly strong, consistent, measured UK view.

Despite being a key centre for finance in Europe, the UK will have only limited voting power on these issues and it is essential, therefore, that UK regulatory authorities speak with full authority and knowledge, presenting one strategic, consistent 'voice' to Europe. Effective coordination between all the regulatory authorities, including the area of the Bank of England responsible for CCPs and settlement systems, will be critical.

Please feel free to contact me if you wish to discuss our comments on the proposals.

Yours faithfully

**Robin Freestone**
*Chairman*
*The Hundred Group – Investor Relations and Markets Committee*

Atlanta Calgary Chicago Houston London New York Singapore

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14 April 2010

Dear Sirs

**HM Treasury Consultation (Cm 8012): A new approach to financial regulation**

ICE is a provider of global markets and clearing services and has invested significantly in the UK. We welcome the opportunity to respond to HM Treasury's further consultation on proposed reform of financial regulation (the "Consultation") and again wish to stress the importance of clarity, continuity and stability in UK regulation.

ICE Futures EU (the 'Exchange'), a UK Recognised Investment Exchange ('RIE'), and ICE Clear EU (the 'Clearing House'), a UK Recognised Clearing House ('RCH'); have set out a joint response below, which builds on our response to the previous consultation (Cm 7874) of 18 October 2010.[1]

**Comments on Consultation Process**

We strongly support the Government's commitment to getting this policy and legislation right, but, particularly given the constrained timeframe, would encourage the openness and proactive consultation this will require. The policies being proposed in the areas which may directly or indirectly impact Recognised Bodies remain high level, with little or no details, evidence or rationale. We would welcome further dialogue in respect of these policies; and publication of the draft legislative text with sufficient time for industry consultation and impact assessment to take place.

**Comments on Proposed Reform of the Recognised Body Exempt Regime[2]**

We strongly support the Government's proposal to retain Part XVIII of the Financial Services and Markets Act 2000 ("FSMA") - the Recognised Body exempt regime.[3] Without sight of the proposed legislative text, we are not in a position to comment as to whether this commitment has been met and are concerned that the references to minor technical changes could nonetheless amount to fundamental and/or detrimental changes to the regime such that the exempt status applies only in name. Specifically:

- **Simplifying the procedure for issuing directions and allowing for penalties to be imposed**

[1]The content of which should be read as being repeated and incorporated herein.
[2] Boxes 2.G question 4; 3b questions 1-6; 4b question 11; and 4.I question 16.
[3] Paragraphs 2.132, 4.114 and 4.115 of the Consultation.

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Exchanges and clearing houses undertake important regulatory and risk management functions, supported by the current Recognised Body regime. Market infrastructure was a key stabiliser during the financial crisis, operating effectively throughout. The regulatory functions and standing of UK Recognised Bodies (both with its users and internationally) should be maintained in a manner consistent with their status of exempt body. Amendment needs:

- evidence and a rationale; and
- new powers to be proportionate, accountable and transparent in their application.

- **Extending information gathering powers.**
Recognised Bodies are currently subject to extensive notification requirements set out in FSMA,[4] the Companies Act 1989[5] and Chapter 3 of the FSA's REC Source Book (the "Notification Rules"). The Notification Rules were made by the FSA under section 293 of FSMA, which gives the FSA broad information gathering powers, including the power to make rules requiring a Recognised Body to provide:

> *"...at such times or in respect of such periods as may be specified, such information relating to the body as may be specified"*

Such Rules extend to a notice or information which is reasonably required for the exercise of the FSA's functions under FSMA. In addition, the Schedule to the Recognition Requirements Regulations[6] requires Recognised Bodies to be able and willing to cooperate by the sharing of information or otherwise with the FSA, with any other authority, body or person having responsibility in the UK for the supervision or regulation of any regulated activity or other financial service or with an overseas regulator. Given the breadth of the current information gathering powers, the need for them to be extended is not immediately apparent, and arguments in support have yet to be made. Further, if demonstrably necessary, any new information gathering powers need to meet the requirements of proportionality, accountability, transparency and relate to specific requirements all within the terms of the proposed legal framework.

**Comments on Strategic/Operational Objectives and Regulatory Principles proposed for the Regulatory Institutions[7]**

We welcome the proposals that the regulatory institutions should have clearly defined objectives and principles.

We note that the proposed objectives and principles of the FCA are:

> *In discharging its functions the FCA must, so far as is reasonably possible, act in a way that :*
>
> *a. is compatible with its strategic objective, and*
> *b. advances one of its operational objectives.*

[4] Sections 293(5), 293(6), 293(7) and 300B(1),
[5] Section 157.
[6] Paragraphs 6 and 20.
[7] Boxes 3.C question 5, 4..B question 11, 4.G question 14, and 4.H question 15

ICE

*The FCA's strategic objective is: protecting and enhancing confidence in the UK financial system.*

*The FCA's operational objectives are:*

- *a. facilitating efficiency and choice in the market for financial services;*
- *b. securing an appropriate degree of protection for consumers; and*
- *c. protecting and enhancing the integrity of the UK financial system.*

*The FCA must, so far as is compatible with its strategic and operational objectives, discharge its general functions in a way which promotes competition.*

*Regulatory principles:*

1. *The need to use the resources of each regulator in the most efficient and economic way;*
2. *The principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;*
3. *The general principle that consumers should take responsibility for their decisions;*
4. *The responsibilities of the senior management of an authorised person in relation to compliance with requirements imposed by or under this Act;*
5. *The desirability in appropriate cases of each regulator making information relating to authorised persons or recognised investment exchanges available to the public, or requiring authorised persons to publish information, as a means of contributing to the advancement by each regulator of its strategic and operational objectives; and*
6. *The principle that the regulators should exercise their functions as transparently as possible.*

As a general point we would encourage the objectives and principles to apply equally to exchange and clearing house supervision. Further, we strongly support the proposal that the FCA's single strategic objective is to protect and enhance confidence in the UK financial system. We also support the proposition that competition is to be encouraged, but not to the detriment of the UK financial system – an example of which being risk management where the promotion of competition could increase systemic risk. Finally, we would note a concern in respect of the disclosures being proposed in principle 5 - Recognised Bodies are an integral part of the regulatory system and handle confidential regulatory, market and other sensitive information which must be kept confidential – we note and support the Consultation's statements that confidential information must be treated appropriately and see no reason to extend the regulatory institutions' powers in this area. In the event that publicity is permitted, this must be clear in advance of submission and/or disclosure to the FCA or any other regulatory institution.

**General Comments**[8]

We agree with, and reiterate, the five key themes identified in the Government's summary response, namely:

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[8] Box 4D, question 12

- The need for the regulatory institutions' core statutory objectives to be balanced and supplemented with other factors;
- The importance of accountability and transparency for the new regulatory authorities;
- The need for a strong, coherent markets regulation function within the FCA;
- The importance of the European and international agenda, both during the transition phase and in steady state; and
- The importance of effective coordination between the new regulatory authorities.[9]

We strongly support the Government's commitment to accountability and transparency of the new regulatory institutions,[10] including, but not limited to appropriate mechanisms, such as consultation, being in place for engagement by the FCA with industry;[11] and that proportionality will be crucial.[12]

More specifically, we agree that:

- In regulating specialised wholesale and markets activities undertaken between professional counterparties, a more nuance regulatory approach will be appropriate.[13]
- The FCA should not be asked to pursue a zero-failure regime – the costs of which would be likely to destroy the markets it sought to regulate. We agree with the Treasury Select Committee - financial markets are primarily about the management and pricing of risk, not its removal. Market infrastructure is key to delivery of this outcome.[14]
- An open and honest relationship with FCA supervisors will require appropriate treatment of confidential information.[15]
- Greater intervention will generally be less appropriate for market participants at the sophisticated or professional end of the spectrum, who do not suffer from the same information asymmetries as retail customers, and for whom the *caveat emptor* principle is a fundamental part of doing business. In line with the proportionality regulatory principle, the regulatory institutions overseeing Recognised Bodies should take a proportionate and tailored approach.[16]

To conclude, we support legislative change which demonstrably contributes to, and does not risk impairing, market efficiency, stability and confidence in the UK financial system. The Consultation contains much which we support, but has yet to provide evidence that amendments to the Recognised Body regime are necessary and will deliver any of these outcomes – not least given the substance of the minor, technical amendments being proposed is not yet known. There remains a real risk of unintended adverse consequences (including detrimental impact on the integrity and reputation of Recognised Bodies as efficient, neutral and trusted bodies) and less flexibility for regulatory oversight and

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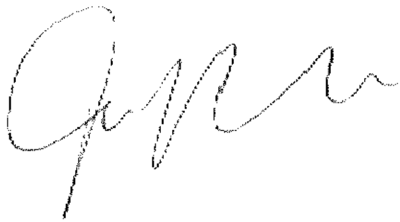
[9] Paragraph 1.17 of the Consultation
[10] Paragraph 1.29 of the Consultation
[11] Para 1.31 of the Consultation
[12] Paragraph 4.9 of the Consultation
[13] Paragraph 4.2 of the Consultation
[14] Paragraph 4.51 of the Consultation and the Treasury Select Committee report *Financial Regulation: a preliminary consideration of the Government's proposals,* February 2011
[15] Paragraph 4.76 of the Consultation
[16] Paragraph 4.101 o the Consultation

ICE

compliance. We would encourage publication of a full and reasoned proposal setting out the failings to be remedied and the intended outcomes.

We look forward to further engagement in this consultative process. Should you like to discuss any of the issues raised in this response, please let us know.

Yours faithfully



**David Peniket**
**President/COO**
**ICE Futures EU**

**Paul Swann**
**President/COO**
**ICE Clear EU**

12 April 2011

Our ref: ICAEW Rep 42/11

Your ref:

Financial Regulation Strategy
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Sir or Madam

***A new approach to financial regulation: building a stronger financial system***

ICAEW is pleased to respond to your request for comments on your consultation paper on *A new approach to financial regulation: building a stronger system*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours faithfully

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ICAEW REP 42/11

## ICAEW REPRESENTATION

A NEW APPROACH TO FINANCIAL REGULATION

**Memorandum of comment submitted in April 2011 by ICAEW, in response to HM Treasury consultation paper *A new approach to financial regulation: building a stronger system* published in February 2011**

**Contents** **Paragraph**


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## INTRODUCTION

**1.** ICAEW welcomes the opportunity to comment on the consultation paper *A new approach to financial regulation: building a stronger financial system* published by HM Treasury.

## WHO WE ARE

**2.** ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

**3.** Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued.

## MAJOR POINTS

### General comments

**4.** Overall we welcome the Consultation Paper (CP). It helpfully develops the proposals set out in the Treasury's earlier CP on a new approach to financial regulation (July 2010), providing considerably more detail on how the new structures should work. ICAEW understands and recognises the pressures for change.

**5.** We particularly welcome the intention to establish macro-prudential machinery, and to emphasise judgement and proportionality in regulation.

**6.** Any significant mismatch between what society expects and what the financial regulatory system is designed to deliver has the potential to lead in due course to accusations of regulatory failure and further to undermine trust in the financial system. In subsequent documents connected to the reform process it might be wise to include some explicit discussion of what the Government believes society expects from its regulatory system.

**7.** We also believe that the proposals could be set more firmly within the context of international, and especially European, developments. For example, as we note below, our understanding is that development of micro-prudential policy will increasingly be moving to the European authorities responsible for banking and insurance / occupational pensions, and that these bodies will pursue a common 'EU rule book'. On the face of it, this seems likely to constrain the scope in future for some types of unilateral action on micro-prudential regulation by the UK.

**8.** It may also be helpful for the authorities to set out the lessons they believe arise from the experience of countries which have operated a 'twin peaks' approach for some time, such as Australia and the Netherlands.

### Financial stability

**9.** While we welcome giving the Bank of England tools with which to pursue financial stability, we believe that caution will initially be required in the deployment of macro-prudential instruments. There is little recent experience of their use, and analytical frameworks to underpin their operation are still in their infancy. It will be important to be alert to possible unintended consequences.

10. Challenges will also arise to the extent that there is less than full reciprocity regarding macro-prudential policy. Where additional requirements are applied to UK firms, there will be a tendency for business to move to foreign firms and/or outside the regulatory perimeter. However, the retail financial services market in the UK remains largely 'local', and that should underpin the effectiveness of macro-prudential policies targeted at retail business (eg mortgage lending).

### Approaches to regulation

11. We strongly believe that the substance of regulatory activity, and its effectiveness, are much more important than formal structures. It is essential that throughout the transition to the new approach there continues to be a strong focus on filling out exactly how it will be made to work in practice. The current FSA and other authorities should consult on this important material well ahead of the new structure going live.

12. We agree that judgement is very important in regulation. It should be exercised within the context of systems at the regulators which are sufficiently strong to deploy it in a way which is well informed, proportionate and consistent across firms and markets. To that end, we recommend that careful attention continues to be paid to governance and accountability mechanisms. In particular it may be appropriate for the PRA and FCA to establish Quality Assurance functions to provide an independent internal assessment of how judgement is being applied. It is crucial that the governance and accountability mechanisms are set up in a way which is supportive of those being called upon to exercise judgement, for otherwise regulators could become excessively risk averse.

13. ICAEW is aware that some in the insurance industry are concerned that the Bank of England group may not pay sufficient attention to insurance issues given that historically the focus of the Bank has been on banking business. It will be important to allay these fears, especially given that the timing of moving to the new approach will be roughly the same as that for adoption of Solvency II.

14. Regarding retail conduct regulation, ICAEW believes that it is necessary to analyse why retail regulation has not met expectations in the last 25 years or so as key background to developing more effective approaches. An important debate about objectives and how best to achieve them has been initiated in particular by the FSA's recent Discussion Paper on *Product Intervention*. We would caution against prejudging the result of that dialogue.

15. We would also stress the importance of the FCA being structured in a way which fosters appropriate focus on all of its functions. In that context, we welcome the proposal in the CP to establish a Markets Panel on a statutory basis.

### Operational issues and the transition

16. The CP contains numerous references to the PRA being able to veto decisions of the FCA in various circumstances. We believe this risks creating the impression that prudential considerations are more important than conduct ones. In our opinion, actions by the FCA in respect of conduct issues would be likely to threaten the disorderly failure of PRA regulated firms, or financial stability, only in rare circumstances. We therefore suggest explictly setting a high bar to the use of the PRA's veto. That would help to underpin the credibility of the FCA with market participants and others at home and overseas.

17. The authorities should be alert to signs of potential overload in the new system. One example is the proposal that the Governor of the Bank of England should, in addition to his duties at the Bank itself and at the MPC, take on the chair of both the FPC and the PRA. This example points to the importance of the different bodies within the new approach having well-designed schemes of delegation within them.

18. In our opinion the new regulators should consider whether for routine functions it would be most efficient if there was a single entity which would provide services, such as collecting regulatory returns, on an outsourced basis to both the PRA and the FCA. Given that the majority of firms by number will be regulated by the FCA, for administrative purposes such a provider could be a subsidiary of the FCA.

19. No specific question is posed with regard to the proposed power to disqualify individual actuaries and auditors (paras 5.92 – 5.97). However, we do not think such a power is necessary with regard to matters arising out of audit work. For auditors, there are existing arrangements to deal with this, maintained by the Recognised Supervisory Bodies for audit and the Financial Reporting Council (FRC).

20. The FSA already has the ability to refer concerns about the performance of individual auditors and actuaries to the FRC's Accountancy and Actuarial Discipline Board (AADB), where matters of public interest arise and a disciplinary investigation is needed. The FSA had not made wide use of this power before the financial crisis, although we are aware that a few cases in respect of client assets have been referred to both the FRC and the Recognised Supervisory Bodies, which are under current disciplinary investigation. The Recognised Supervisory Bodies already have the powers to disqualify individual auditors, either from auditing entirely or from a class of audits. However, such decisions can only be made if appropriate evidence is provided by the FSA and due process, including the right of appeal, is followed. ICAEW's processes are overseen by the FRC's Professional Oversight Board. Overall, we therefore do not think the case for new powers, to the extent that they would apply to audit work, has been established.

21. Regarding the transition, it is widely acknowledged that there are numerous risks, both for the regulators, particularly potential loss of high-quality FSA staff, and regulated firms, which at present do not have sufficient detail in order to prepare for the new arrangements. We urge the authorities to promulgate a reasonably detailed transition plan as soon as possible.

22. We note that high ability and/or considerable experience are likely to be prerequisites if front-line regulators are to have the skills to deliver genuinely judgement-led regulation. That has implications for remuneration and the costs of the regulatory system both through the transitional period and beyond, which needs to be borne in mind in planning the likely shape of the PRA's and the FCA's finances.

## RESPONSES TO SPECIFIC QUESTIONS

### Q1: What are your views on the likely effectiveness and impact of these instruments as macro-prudential tools?

23. The FPC should take into account the fact that financial innovation is likely to be prompted by the use of these instruments. To the extent that a regulatory instrument imposes a binding constraint on private sector portfolio choices, an incentive to work round it is created. That would reduce the effectiveness of such instruments, and is something which will need to be borne in mind in calibrating the extent to which the instruments are deployed (eg the magnitude at any given time of a counter-cyclical capital buffer).

24. More broadly, some 'leakage' in the effectiveness of the instruments is likely to the extent that macro-prudential policy was operated on a UK-only basis. There is a risk that restrictions which bite on UK-authorised firms could be undermined to some degree by the activities of foreign firms not subject to UK prudential rules (eg branches of EU banks operating in the UK). However, to a considerable extent retail financial markets in the UK are still 'local', so we would expect macro-prudential instruments targeted at retail business (eg mortgage lending) to be quite effective.

**25.** An important challenge in using the instruments counter-cyclically is being able to reduce requirements in downswings. Market pressures, especially in times of clear stress, might make that difficult in practice. For example, under stressed conditions market participants might draw comfort if 'high' levels of bank capital had been built up in a previous, benign period – and might be reluctant to see bank capital falling even if there was a clear macro-prudential rationale for that. Very clear on-going communication by the FPC to the market (and the public generally) would help to mitigate this risk.

**26.** We agree with the Government that the FPC's tools must be ones for which there is sufficient national discretion. In particular, we welcome the recognition (para 2.45) that accounting standards for listed companies are those determined internationally by the International Accounting Standards Board (IASB), as adopted by the European Union. This means that it would not be possible for the FPC to alter the principles underlying company annual and interim financial statements.

**Q2: Are there any other potential macro-prudential tools which you believe the interim FPC and the Government should consider?**

**27.** We have no comments on this question.

**Q3: Do you have any general comments on the proposed role, governance and accountability mechanisms of the FPC?**

**28.** Given that the instruments available to the FPC are largely untested in recent UK experience, we believe that a judicious approach should be taken to their use. We therefore very much agree with the CP (para 2.49) that the FPC should be required publicly to set out its rationale when any instrument is used and the impact sought, and to establish a mechanism for ongoing ex post evaluation of the effect in practice.

**29.** We believe that it is important that the FPC has at least two members with recent top-level experience in the financial sector. This will assist the FPC in gathering and assessing market intelligence and in analysing the full implications of possible actions to promote financial stability. The CP takes the same view (para 2.78). We are therefore somewhat concerned that very few members of the interim FPC appear to have relevant private sector experience.

**30.** We support the suggestion that the Government should look at making provisions regarding management of any conflicts between the resolution authority and the prudential regulator regarding crisis management (para 2.152). It is conceivable that conflict could arise given that the PRA and the resolution authority will have separate boards of directors.

**Q4: Do you have any comments on the proposals for the regulation of systemically important infrastructure?**

**31.** Given the division of responsibility envisaged between the Bank and the FCA for regulation of this core infrastructure, as the CP recognises close co-ordination between these bodies will be essential – not least in relation to UK representation in ESMA.

**Q5: What are your views on (i) the strategic and operational objectives and (ii) the regulatory principles proposed for the PRA?**

**32.** We broadly agree with the objectives and principles as set out in the CP.

**33.** It will be important to ensure that the strategic objective of financial stability, and the principle of proportionality, does not lead in practice to insufficient attention being paid to smaller deposit takers and insurance companies. This is partly a matter of ensuring that they are subject to effective prudential supervision but also ensuring that they receive sufficient support in meeting regulatory requirements, bearing in mind the more restricted resources of smaller firms. It would not be desirable if the market attached a higher risk premium to smaller firms because of a perception that they were subject to less effective regulatory oversight.

**34.** The PRA should establish and maintain rules appropriate to firms of all sizes and levels of sophistication for which it is the prudential regulator, including simplified approaches for smaller or less sophisticated entities (to the extent this is possible under the relevant EU Directives).

**35.** The unqualified reference in the PRA's objective of 'safety and soundness' could be taken as something close to a 'zero failure' regime. For the avoidance of doubt it might be appropriate to include explicit reference to allowing firms to fail in the regulators' objectives and/or the regulatory principles.

**36.** We strongly agree with the principles relating to the regulators being as transparent as possible, including making information on authorised firms and recognised exchanges available in appropriate cases. However, we would stress the importance of the primary legislation requiring that decisions on publication of information on specific entities, or particular individuals, have full regard to their legitimate rights. The regulators would need to be mindful of the likely impact on a firm's / individual's reputation of any publication before an issue had been finally determined.

**37.** Given that the FCA will be setting some prudential rules, including for a limited number of 'prudentially significant' entities, in our view care will need to be taken to ensure that the two sets of prudential rules are consistent to the extent that is appropriate, bearing in mind the different types of entity to be regulated by the PRA and the FCA. Close co-operation between PRA and FCA policy staff should ensure this.

**Q6: What are your views on the scope proposed for the PRA, including Lloyd's, and the allocation mechanism and procedural safeguards for firms conducting the 'dealing in investments as principal' regulated activity?**

**38.** We strongly welcome the recognition (para 3.22) that the special charateristics of insurance should be taken into consideration in designing the regulatory approach which applies to insurance companies.

**39.** We also welcome the principle that investment firms would be designated only where they pose risks which can be mitigated through prudential regulation. In designating firms, the balance between objective criteria and judgement is not made entirely clear in paras 3.24 - 3.26. While accepting that an element of judgement will be required, as the consultation paper acknowledges this should be exercised within a clear framework of published principles, and be subject to proper due process.

**40.** ICAEW is aware that some investment firms are concerned that they are, at present, unclear whether they will fall under PRA regulation or not. It would help to reduce uncertainty in the market if more information on the likely designation criteria could be promulgated as soon as possible. This information would also throw light on whether or not there is a risk of significant numbers of investment firms potentially migrating into and out of the scope of PRA regulation over time if there are changes in their business model or other relevant factors.

**41.** Given the scope for innovation in finance, it is important that the perimeter of regulation generally can be altered fairly quickly should the FPC conclude that is necessary in order to protect financial stability.

**Q7: What are your views on the mechanisms proposed to make the regulator judgement-led, particularly regarding: rule-making; authorisation; approved persons; and enforcement (including hearing appeals against some decisions on more limited grounds for appeal)?**

**42.** We believe that judgement is a key feature of an effective regulatory regime. However, it is essential that such judgements are made within a well-defined, published regulatory

framework. It should be possible to appeal not only on points of law but also on the substance of a significant regulatory decision.

**43.** It may prove challenging to take enforcement action on the basis of 'purposive' interpretations of the regulatory rules, as opposed to evidence that one or more rules were not complied with. One reason is that there could be a substantive difference of view between a regulated firm and the PRA as to whether the purpose of a rule had been met or not, particularly in complex situations in which, for example, it might be arguable that a range of different actions taken together had adequately met the purpose. This is an area where further dialogue with the legal community could prove helpful.

**44.** In view of the untested nature of these legal arrangements, as well as the proposed concentration of powers in the Bank of England group, we consider that it would be inappropriate for the grounds for appeal to be narrowed at the present time.

**Q8: What are your views on the proposed governance framework for the PRA and its relationship with the Bank of England?**

**45.** The CP states that the PRA board should 'perform a robust challenge function' (para 3.47). In that context, we believe it would be appropriate for the power to make appointments of non-executive directors to the PRA board to be vested specifically in the Court of the Bank of England, as opposed to the Bank more generally. The Court would bring a diverse range of backgrounds and experience to bear on making these critical appointments.

**46.** In view of the emphasis being given to judgement-led regulation, we believe that the legislation should require the PRA board to establish an independent Quality Assurance function the key purpose of which would be to review whether judgement is being applied appropriately and consistently. (We would recommend that the FCA also establishes a Quality Assurance function).

**47.** It is not entirely clear why approval of the PRA's remuneration policies for staff – as opposed to the overall budget – should be reserved to the Court of the Bank (para 3.43). The impact assessment states (page 117) that there is an expectation that costs of prudential regulation will fall in the medium term following, amongst other things, adoption of the 'new judgement-based regulatory model'. We would be concerned if that were to be delivered through curtailing remuneration of regulatory staff in a way which had an adverse effect on the recruitment and retention of high quality employees. The complexity of modern finance means that it is essential that a significant proportion of regulatory staff have appreciable private sector experience.

**Q9: What are your views on the accountability mechanisms proposed for the PRA?**

**48.** We support the mechanisms proposed in the CP.

**Q10: What are your views on the Government's proposed mechanisms for the PRA's engagement with industry and the wider public?**

**49.** We agree with the Government's view that there should be no significant reductions to the exisiting requirements to consult as set out in FSMA (para 3.66). In our view, consultation about proposed rules is particularly important, both as a mechanism for the regulator to benefit from the insights of stakeholders, and also because of the legal status of these rules.

**50.** It is not clear to us why the CP suggests giving the PRA very considerable flexibility in deciding how to engage with practitioners and the wider public. This aspect is an important one in terms of the effectiveness of regulation and 'checks and balances' in the system, and we would be more comfortable if minimum requirements were set out in primary legislation. We are aware of a certain amount of dissatisfaction on the part of market participants that the future of the existing FSMA Panels in relation to the work of the PRA is unclear at present.

**51.** Amongst others, the PRA will need to engage closely with auditors (as already set out in the FSA's draft Code of Practice for the relationship between the external auditor and the supervisor, February 2011). In that context, in our view in addition to the existing legal duties under FSMA for auditors to report to the FSA on certain matters, we believe that the revised financial regulation legislation should place a duty on the PRA and the FCA to communicate to a regulated firm's statutory auditor any information that is likely to be materially relevant to their audit work. That would be consistent with Principle 3 of the Code, where it is stated that: 'the presumption should be that the supervisor will want to share any information it has that is likely to contribute to higher quality audits'.

**Q11: What are your views on (i) the strategic and operational objectives and (ii) the regulatory principles proposed for the FCA?**

**52.** We consider the objectives and principles to be broadly appropriate. However, we would prefer to see a more explicit focus on making the retail market work as well as possible for consumers. Achieving that will require a careful analysis of the shortcomings at present. In our view, it is not clear that a major issue is a lack of 'efficiency and choice' and we wonder whether that is appropriate as one of the operational objectives. The single most important problem is probably the asymmetry of information between producers and consumers.

**53.** It is not clear that it is appropriate for a 'small population' of 'prudentially significant' firms (Box 4.E) to be regulated by the FCA. If they are 'prudentially significant' they are likely to have some capacity to pose a systemic risk, and so would fit more naturally into the PRA. The fact that the PRA will possess most of the expertise on prudential issues within the UK regulatory system points in the same direction.

**54.** We are concerned that it is not proposed that the FCA should be given an operational objective of reducing financial crime (even – apparently – as part of the 'integrity' objective), and indeed by the limited attention to this subject in the CP. Economic crime can have very corrosive long-term effects on economic efficiency, and it is important that the subject receives proper attention. The FSA has recently had some notable successes in this sphere, and this momentum should not be lost.

**55.** In view of the proposals that anti-money laundering and market abuse cases should be handled by the FCA, we are not entirely sure what role the proposed Economic Crime Agency will play. We also note that Box 4.C (page 66) does not set out information-sharing and gateway arrangements among the rather numerous agencies which deal with facets of financial crime.

**56.** In line with the thrust of recent FSA initiatives, greater emphasis should be given to protection of client assets. This function of the FCA is critical – from the viewpoint of consumer protection in normal times and facilitating resolution of firms threatened with insolvency (which is greatly complicated if client assets are not properly segregated).

**Q12: What are your views on the Government's proposed arrangements for governance and accountability of the FCA?**

**57.** These seem to be largely modelled on those of the FSA, and in themselves do not raise any particular issues. However, we believe that the governance and accountability mechanisms should be framed in a way which will ensure that sufficient attention is paid to all of the main types of regulatory activity in the FCA. In view of the global significance of the wholesale financial markets in the UK, it is particularly important that markets regulation is given appropriate prominence. We therefore welcome the proposal to establish a Markets Panel on a statutory basis (para 4.39).

**Q13: What are your views on the proposed new FCA product intervention power?**

**58.** The CP includes quite extensive discussion of actions, such as product bans, which could be seen as prejudging the FSA's recently issued Discussion Paper on *Product Intervention*. We recommend that the Treasury takes full account of responses to that DP when available.

**59.** The possibility of product bans in particular raises some fundamental issues. For example, a power to ban specific products likely to cause significant consumer detriment could inadvertently create an impression that the FCA will proactively examine all products on sale to the retail market – to check whether they should be banned. The Treasury and FCA will need to consider how best to lean against such an expectation developing. That said, we believe a case may exist for well targeted product bans – we are aware of some products which have been marketed to consumers that were unlikely to be suitable for almost any client.

**60.** The strong nature of the product intervention powers envisaged suggests that the relevant framework should perhaps be set out in primary legislation rather than in FCA rules (para 4.64). In our view there are some emerging indications that the FCA might in some way become involved in regulating the pricing of retail products. Given that this would be a major step to take, were it the intention that should also be made explicit in primary legislation.

**Q14: The Government would welcome specific comments on:**

- **the proposed approach to the FCA using transparency and disclosure as a regulatory tool;**
- **the proposed new power in relation to financial promotions; and**
- **the proposed new power in relation to warning notices.**

**61.** As stated above in the case of the PRA, we support appropriate transparency and disclosure, so long as the rights of firms and individuals are properly respected. In particular, we believe that publication of warning notices before a final determination would be unjust, because publication has the potential to lead to serious reputational damage to a firm. It is important that regulatory processes substantively preserve the presumption of innocence until due process is completed and an adverse conclusion is reached.

**Q15: Which, if any, of the additional new powers in relation to general competition law outlined above would be appropriate for the FCA? Are there any other powers the Government should consider?**

**62.** We agree with the emphasis given to fostering competition, and are sympathetic to addressing competition issues more quickly. There are some markets – for example aspects of retail banking – where it is widely felt that stronger competition would be highly desirable. However, we note that the Government is reviewing the competition regime more generally, so it is difficult at this point to envisage how the FCA could best contribute to competition policy.

**63.** In our view it would not be appropriate for the Consumer Panel to have the ability to trigger a super-complaint process. This would not be consistent with the Panel's role in providing independent oversight of the FCA's policy development and regulatory activity from the perspective of consumers.

**Q16: The Government would welcome specific comments on:**

- **the proposals for RIEs and Part XVIII of FSMA; and**
- **the proposals in relation to listing and primary market regulation.**

**64.** We have no comments on this question.

**Q17: What are your views on the mechanisms and processes proposed to support effective coordination between the PRA and the FCA?**

**65.** Effective co-ordination between the PRA and the FCA will be essential – bearing in mind that all authorised firms will be subject to the FCA.

**66.** The CP deals mainly with co-ordination at a very senior level and on major issues. But it will be just as important that there are close links between the staff in the two organisations at every level. There is a danger that over time the two regulators will tend to drift apart, due to factors such as the rather different subject matter they will deal with, and the possibility of some 'cultural' differences emerging between them.

**67.** We believe further proposals should be developed as to how a culture of co-operation can be embedded throughout both the PRA and FCA. This is partly a matter of 'tone at the top', but some specific mechanisms could help too. For example, the PRA and FCA boards could meet jointly from time to time on an agreed schedule, and they could establish a public forum where they would meet representatives of dual-regulated firms to discuss how well co-operation appeared to be working in practice. Co-operation could also be a specific subject considered in the annual reports of the PRA and the FCA.

**68.** In terms of day to day working, it would probably be helpful for the PRA and FCA to put in place arrangements for cross secondments of staff – though to make an appreciable difference to co-operation, the number of staff who had been seconded for a period would need to be a significant proportion of the total.

**69.** From an efficiency and economy perspective in relation to the resources of both regulators and firms it will be important for the PRA and FCA to develop working practices which encourage each of them to place as much reliance as possible on the work of the other. This is especially significant in areas where both the PRA and the FCA will have a clear interest, such as governance and systems and controls more generally.

**70.** A particularly notable challenge will be to ensure sufficient co-ordination in the supervision of groups in which there are both PRA- and FCA- regulated entities. It is crucial to avoid conflicting or inconsistent regulatory judgements (or indeed duplication of work) being applied to different entities within a group.

**Q18: What are your views on the Government's proposal that the PRA should be able to veto an FCA taking actions that would be likely to lead to the disorderly failure of a firm or wider financial instability?**

**71.** In our view, actions by the FCA in respect of conduct issues would be likely to threaten the disorderly failure of PRA regulated firms, or financial instability, only in rare circumstances. We therefore recommend explicitly setting a high bar to use of the PRA's veto. The rather frequent references to the veto in the consultation paper could appear to suggest that the FCA was in some way subordinate to the PRA – which would not be consistent with the Government's position that 'the PRA and FCA will be equal in status' (para 5.6).

**Q19: What are your views on the proposed models for the authorisation process – which do you prefer and why?**

**72.** It would be less cumbersome and more efficient if one of the new regulators was responsible for mantaining the machinery to deal with authorisations, with the other providing input. As the FCA will regulate the largest number of authorised firms and individuals, it would make sense for the FCA to take on this role, but with a clear position that the PRA would need to consent to authorisation of any PRA-regulated activity being undertaken.

**73.** A similar approach might be most efficient for various other regulatory processes.

**Q20: What are your views on the proposals on variation and removal of permissions?**

**74.** We broadly agree with the proposal, though we would caution against the PRA using its veto in other than exceptional circumstances. Use of the veto would be tantamount to the PRA condoning the continuation of financial conduct which the FCA had judged to be unacceptable.

**75.** We note that withdrawal of one or more FCA permissions would not necessarily immediately compromise the financial viability of a firm. That would depend on factors such as the permissions in question, the capital of the firm and so on. Where a firm would remain viable in the short term, use of the PRA veto should be unnecessary.

**Q21: What are your views on the Government's proposals for the approved persons regime under the new regulatory architecture?**

**76.** It does not appear appropriate for the PRA to have sole right of final decision for positions in which there is an FCA as well as PRA interest (eg Chief Executive). It would be better for both authorities to have to consent where both have an interest.

**Q22: What are your views on the Government's proposals on passporting?**

**77.** We agree with the proposals, subject to suitable arrangements for the FCA to provide the PRA with relevant information on firms passporting into the UK from elsewhere in the EU.

**Q23: What are your views on the Government's proposals on the treatment of mutual organisations in the new regulatory architecture?**

**78.** We very much agree that the regulatory system should not favour or disadvantage particular ownership models. We also agree that, in principle, registration of mutual organisations not engaged in providing financial services does not naturally fit into the FCA's responsibilities. However, it will be important to pay close attention to the costs (both direct and compliance) of any proposal to move registration of mutuals away from the FSA / FCA.

**Q24: What are your views on the process and powers proposed for making and waiving rules?**

**79.** Given that PRA and FCA rules will have broadly the same status as secondary legislation, we are strongly of the view that the process disciplines applied to the making of FSA rules should continue, especially the requirement for public consultation on all rule changes.

**80.** We consider that, in the interests of transparency, the current FSA approach in which waivers are almost always published should be retained by both the PRA and the FCA.

**Q25: The Government would welcome specific comments on:**

- **proposals to support effective group supervision by the new authorities – including the new power of direction; and**
- **proposals to introduce a new power of direction over unregulated parent entities in certain circumstances.**

**81.** We endorse the view that effective regulation of individual entities requires close attention to the groups to which they belong (where relevant).

**82.** In our view, the CP does not make clear how the PRA veto power could apply to FCA-directions needed to meet EU requirements relating to consolidated supervision (para 5.70) – would use of such a veto be compatible with the UK's obligations under EU law?

**83.** We do not object to a power of direction over unregulated parent entities in specific circumstances, provided there are safeguards along the lines set out in the CP.

**Q26: What are your views on proposals for the new authorities' powers and coordination requirements attached to change of control applications and Part VII transfers?**

**84.** We agree with the approach set out in the CP.

**Q27: What are your views on the Government's proposals for the new regulatory authorities' powers and roles in insolvency proceedings?**

**85.** We agree with the approach set out in the CP.

**Q28: What are your views on the Government's proposals for the new authorities' powers in respect of fees and levies?**

**86.** We believe that the proposals in the CP need to be developed in greater detail. In our view, both the PRA and FCA should be required to publish annual documents which set out their business plan, proposed budget and calculation of fees applicable to different classes of firm. (as well as an annual report and audited annual accounts). In the case of the PRA, from a transparency and accountability perspective it is important that detailed financial information relating to its operations is publicly available. This should not be obscured by information being confined just to what will be available in the Bank of England's consolidated (group) accounts (which may present only summary information on the PRA, as just one part of the group).

**Q29: What are your views on the proposed operating model, coordination arrangements and governance for the FSCS?**

**87.** It may prove challenging to operate a structure in which two bodies, the PRA and the FCA, will make rules in relation to the FSCS, especially as some rules are likely to apply to both PRA- and FCA-regulated activities. There could be policy disagreements, for example regarding where the balance is struck between protecting consumers and minimising moral hazard. One way of mitigating this risk would be to ensure that the FSCS itself has a strong board.

**Q30: What are your views on the proposals relating to the FOS, particularly in relation to transparency?**

**88.** We are aware of concerns within the financial services industry that in practice FOS decisions can have policy making implications – but without the accountability of rule making by the FSA. Publication of FOS decisions would presumably accentuate these concerns. This suggests that the policy significance of FOS actions should be clarified as part of any move to publication.

**Q31: What are your views on the proposed arrangements for strengthened accountability for the FSCS, FOS and CFEB?**

**89.** We have no comments on this question.

**Q32: What are your views on the proposed arrangements for international coordination outlined above?**

**90.** We believe that in further development of the new approach to UK financial regulation more explicit attention should be given to the extent to which UK financial regulation is becoming embedded within a broader international and particularly European system, in the light of developments such as the strengthening of the G20 process and establishment of the European authorities for banking, insurance and securities markets.

**91.** Our understanding is that development of micro-prudential policy will increasingly be moving to the European authorities responsible for banking and insurance / occupational pensions, and that these bodies will pursue a common 'EU rule book'. On the face of it, this seems likely to constrain the scope in future for some types of unilateral action on micro-prudential regulation by the UK.

**92.** However, we note that greater freedom of action is likely to exist with respect to macro-prudential policy given that the UK is outside the euro area. Here, as noted above, the main issue is likely to be the extent to which other countries adopt a macro-prudential approach similar to the UK, and the challenges of applying something significantly different just in the UK if they do not do so.

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CAP/BBJ

13th April 2011

Financial Regulation Strategy
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Dear Sirs

**IIB response to HM Treasury**
**A new approach to financial regulation: building a stronger system**

This response is on behalf of the Institute of Insurance Brokers (IIB), a trade association for insurance brokers throughout the UK. Our members provide a vital service to consumers and businesses in their role as professional intermediaries, advisers and risk managers. Under the proposed new regulatory arrangements our members will become regulated both for prudential and conduct purposes by the Financial Conduct Authority (FCA) and we have therefore restricted the scope of our response to the questions relating to the FCA.

It is a widely held view that FSA regulation, designed for banking and investments, was imposed inappropriately on insurance intermediaries with the result that the level of regulation exceeds the limited risks posed by brokers. As we see it, the development of the new regulatory regime presents the Government with an ideal opportunity to facilitate a fairer, more proportionate approach to our sector. To date however, the effect on smaller firms of the proposals for regulation by the FCA does not appear to have been properly examined. This is worrying and surprising bearing in mind that smaller firms represent around 90% of all regulated firms. Such businesses are relied upon throughout the country to provide insurance and investment advice and other important services and we fear that the ill-considered introduction of a raft of new regulatory measures would affect firms' morale and viability, especially in the difficult trading conditions which prevail. Clearly, insurance brokers and some other small financial services firms do not present a systemic risk and we would urge the Government to stand by its pledge to cut the burden of bureaucracy for small firms as part of the package of regulatory reforms.

The timetable for the implementation of the substantial regulatory changes is short. Under the FSMA 2000, the Government and regulators must consult formally regarding changes in legislation, statutory instruments, rules and guidance. We regard consultation as a very important procedure which connects with market participants and consumers and helps to inform the rule-making process, particularly on practical matters. Given the diversity of firms in the financial services industry and the array of issues the regulators seek to address, we feel it is essential that stakeholders are given the time and opportunity to contribute towards the establishment of the new regime. The Government should ensure that the FCA or PRA does not introduce, through expediency, inappropriate measures which could hinder market

efficiency and competition, particularly in some of the lower-profile, yet economically and socially important, sections of the market.

Please contact us if you require any further details or wish to discuss any of the matters raised.

Yours faithfully

Ann Peel FCII
**Head of Technical Services**

*Email: ap@iib-uk.com*

## IIB answers to questions 11-31 only concerning the FCA
## A new approach to financial regulation: building a stronger system

**Question 11: What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the FCA?**

We support the FCA's strategic objective to protect and enhance confidence in the UK financial system and we are in favour of the operational objectives, in particular facilitating efficiency and choice. The Government says it wants to see a wide choice of products, services and providers. To this end we would advocate the removal of regulatory barriers wherever possible. In maintaining and promoting a competitive marketplace, the FCA should seek to ensure that competitive forces operate positively to improve the experience of consumers while inspiring firms to develop and innovate.

In establishing the new regulatory bodies lessons must be learnt from the shortcomings of the FSA approach which, in our view, has not resulted in significantly improved outcomes either for consumers or for financial firms. Despite the plethora of rules and guidance, it is clear that poor practice has persisted in some areas. The problems over PPI, bank charges and endowment mortgages provide clear evidence that the FSA regime, though expensive and resource intensive, has not been as effective as it needs to be. The Treasury admits in the consultation document; '*although a super-complaint over PPI was first launched by the Citizens Advice Bureau in September 2005, a package or remedies was not implemented until 2010*'. Regulatory failure such as this has led to a lack of consumer confidence and to enormous remedial costs being borne by innocent firms. The decline in the availability of independent advice for consumers, which has coincided with a significant reduction in the numbers of insurance broking firms, is exacerbated by the disproportionate demands of the regulatory system and spiralling compliance costs.

**Question 12: What are your views on the Government's proposed arrangements for governance and accountability of the FCA?**

We are concerned that, as the FCA will be created using the existing FSA infrastructure, it will be 'business as usual' with the main discernable change being the redesign of the corporate logo. Whilst we appreciate the need to minimise the cost of change and disruption for staff, we feel the new regulator must take bold and decisive measures to overcome the root causes of poor and inappropriate regulation. We would therefore expect the board and executives to act decisively in transforming the regulatory process into one which is relevant, accountable and cost-effective. In our view, that would involve replacing as far as possible the arcane Handbook of Rules and Guidance to establish clear rules of conduct, tailored for specific sectors of the market.

We note the Government intends to legislate for practitioner and consumer panels and expect that most insurance brokers and other insurance intermediaries will be represented on the Smaller Business Practitioner Panel (SBPP). As we stated in our response to earlier consultation, the effectiveness of such a panel is likely to be constrained by the diverse range of interests it represents. The current SBPP includes representatives of IFAs, credit unions, mortgage brokers, asset managers, friendly societies and small mutual insurers as well as insurance intermediaries, which have little in common with each other in terms of

products, business practice or regulatory focus. Nevertheless, the panel has to deal with many technical issues which are relevant to a particular activity.

It is essential that the FCA be well informed and motivated to act decisively on matters which concern the lower-profile sectors of the market but the constitution and remit of the SBPP needs to be carefully thought out. We would like to see the experience and expertise of practitioners from each sector better utilised in helping to develop and maintain standards in their respective areas; perhaps, through the establishment of specialist consultative panels or sub-committees and/or the participation of trade associations.

The high cost of regulation is an ongoing issue, bearing in mind that the costs borne by UK insurance brokers greatly exceed those in the rest of Europe. We therefore welcome the intention to make the FCA subject to audit by the National Audit Office.

**Question 13: What are your views on the proposed new FCA product intervention power?**

We agree that a change in regulatory approach is needed to prevent or mitigate mis-selling and accept that the new regulator needs to be equipped to intervene at an early stage where consumer detriment is a possibility. However, we feel there is a danger that a product-based approach could place too much attention on the product itself, rather than on the way that the product is sold and marketed. The payment protection insurance (PPI) debacle provides a good illustration – although most PPI insurance policies (the products) are intrinsically sound and worthwhile, they have been mis-sold widely through commission-driven banks and credit brokers that failed to take into account customers' personal circumstances and/or to make inadequate disclosures. It would be essential to consider the risks arising through the entire value chain but we fear that product intervention powers used narrowly or in isolation may not address some of the root causes of consumer detriment.

We support the proposal to require the FCA to publish and consult on a set of principles governing the circumstances under which it will use any product intervention power. These new rules must be introduced with caution so that they do not have the effect of stifling enterprise and innovation. With this in mind, we would like the FCA to ensure that these powers do not evolve into a formal product pre-approval regime.

**Question 14: The Government would welcome specific comments on:**

**the proposed approach to the FCA using transparency and disclosure as a regulatory tool;**
Greater practitioner involvement in developing policies, rules and standards would, in our view, provide a valuable contribution to transparency. Notice of regulatory board/panel agendas could stimulate more external interest which, in turn, could help inform and assist the decision making processes. We would also like to see minutes of board meetings being made publicly available. Engagement by stakeholders in the regulatory process would also be encouraged by holding regular public meetings where board or panel members would deal with questions. We note there will be a complaints mechanism similar to the existing FSA arrangements.

**the proposed new power in relation to financial promotions;**
We agree with the proposal to legislate to give the FCA power to direct a firm to withdraw or amend misleading financial promotions and to publish the fact that it has done so, subject to the firm having a right of appeal to the Upper Tribunal.

**the proposed new power in relation to warning notices.**
Whilst it would be desirable, in most cases, to highlight problems to consumers at an early stage we are concerned that publication by the regulator of the fact that a warning notice has been issued might exacerbate a problem which might have been capable of being resolved out of the public eye. Clearly, there is a risk of unwarranted reputational damage to the firms concerned. We would therefore expect the regulator to exercise caution and discretion over when and in what circumstances a warning notice will be issued.

**Question 15: Which, if any, of the additional new powers in relation to general competition law outlined above would be appropriate for the FCA? Are there any other powers the Government should consider?**

Undoubtedly, the FCA will be in a good position to identify and address competition issues and we believe the body should be able to have powers under general competition law to supplement its usual regulatory powers. A limited form of concurrency would be best achieved, in our view, through market investigation reference (MIR) powers, especially as this could allow the regulator to resolve some issues without making a referral to the Competition Commission.

**Question 16: The Government would welcome specific comments on RIEs/listing.**

We have no comment on this.

**Question 17: What are your views on the mechanisms and processes proposed to support effective coordination between the PRA and the FCA?**

We agree that the PRA and FCA should have a statutory duty to coordinate the exercise of their functions and the arrangements should be clarified in a Memorandum of Understanding. There is an obvious need to avoid duplicate or uncoordinated action which could be costly for firms such as insurance companies which will become dual-regulated. We also agree that cross membership on regulatory boards would be beneficial.

**Question 18: What are your views on the Government's proposal that the PRA should be able to veto FCA taking actions that would be likely to lead to the disorderly failure of a firm or wider financial instability?**

It makes sense to guard against the possibility that the FCA could take action which results in disorderly failure or causes wider financial instability. However, it is not clear how the power of veto would operate in respect of firms which are regulated solely by the FCA and we would like the Government to clarify its intentions in this regard.

**Question 19: What are your views on the proposed models for the authorisation process?**

We prefer the 'one authority' approach whereby the FCA would process all applications, referring, where necessary to the PRA. However, we are aware that the current authorisation process is often slow and laborious. The new regulators should therefore review existing procedures with a view to streamlining the process as much as possible.

**Question 20: What are your views on the proposals on variation and removal of permission?**

We agree that powers to vary or remove permissions should be available to both bodies.

**Question 21: What are your views on the Government's proposals for the approved persons regime under the new regulatory architecture?**

We agree that for firms it regulates, the FCA should have full power to designate controlled functions and to approve individuals to undertake those functions. Again, we are aware of firms experiencing considerable delays in the processing of approvals by the FSA and there is a clear opportunity here to streamline matters. The proposed arrangements for dual-regulated firms appear messy and the idea of separating controlled functions between those with prudential significance and others may result in confusion and individuals being overseen by different regulators in respect of their different functions.

**Question 22: What are your views on the Government's proposals on passporting?**
We agree that the passporting process for overseas firms should be the responsibility of the FCA.

**Question 23: Re mutuals n/a**

**Question 24: What are your views on the process and powers proposed for making and waiving rules?**

We agree that each authority should be able to consent to the modification or disapplication of the rules it makes.

**Question 28: What are your views on the Government's proposals for the new authorities' powers in respect of fees and levies?**

We wholeheartedly agree that the resources of the new bodies should be used efficiently in order to keep costs as low as possible. At present there seems to be a lack of transparency over the FSA budget and the allocation of costs/fees between activity groups. The consultation process does little to reassure regulated firms about the value their substantial

fees represent and this leads to doubt as to whether resources are being used wisely and effectively. Bearing in mind the relatively low risks their activities pose, we have long argued that the cost/fee basis needs for insurance brokers and other small intermediary firms need fundamental revision. The problem is highlighted by research (Charles River Associates – Future Regulation for insurance brokers; prepared for BIBA; March 2011) which confirms that insurance brokers in the UK are forced to bear huge regulatory costs compared to their European counterparts.

We agree that each authority should be able to charge fees to its own authorised persons or entities but we would like to see a more open and transparent system for budgeting and cost allocation. There must be effective coordination between the authorities to ensure fairness, especially for dual-regulated firms, and it makes sense to arrange for the actual collection of all fees and levies by one organisation.

**Question 29: What are your views on the proposed operating model, coordination arrangements and governance for the FSCS?**

Undoubtedly, the compensation scheme plays an important role in maintaining consumer confidence in the financial system and will be necessary to underpin the objectives of both the PRA and FCA. However, it must be remembered that the FSCS is a scheme of last resort and its existence is testament to inherent failings in the regulatory system. Rather than promoting the fact that customers can readily obtain redress (as seen in recent TV advertising by the FSCS), we feel that the new authorities should concentrate on preventing defaults, most of which result from liabilities incurred through mis-selling.

Clearly, the intention is to retain the FSCS as a single point of contact for compensation matters but, in future, the scheme will serve two different regulatory masters. We agree that a memorandum of understanding (MoU) between the PRA and FCA should cover coordination and that the FSCS should be required to put in place a MoU with each regulator. We feel it is vital that FSCS board members are seen to be independent and agree that the Treasury should retain its right of approval over the appointment of the Chair. Notwithstanding these comments which are generally supportive of the Government's proposals, we must reiterate our concerns over the funding arrangements for the FSCS which are controversial and, as far as insurance brokers are concerned, patently unfair. Huge levies to pay for the mis-selling of payment protection insurance by failed credit intermediaries have threatened the viability of many innocent professional firms which have never sold such products. Furthermore, small firms including insurance brokers are exposed to the liabilities of banks and other large institutions because of cross-subsidisation. The FSA has delayed consulting on a new funding model for the FSCS because of international developments but we urge the Government to take action on this matter as quickly as possible so that new rules could be in place by April 2012.

**Question 30: What are your views on the proposals relating to the FOS, particularly in relation to transparency?**

We have no objection to the FCA taking on the FSA's existing functions in relation to the FOS providing it remains operationally independent and accept that an MoU between the FOS and the FCA should be in place to formalise coordination and cooperation between the bodies. The ramifications of the proposed requirement for the FOS to pass information to the FCA need to be fully explored so that the FOS does not acquire a quasi-regulatory role by default As a trade body we have previously criticised the lack of formal appeal rights for

firms which operate under the FOS compulsory jurisdiction. Any decision of the FOS is binding on the firm, but the consumer is able to reject the decision and take legal action against the firm. The need for transparency is obvious, bearing in mind the absence of a right of appeal and the extent of discretion which the FOS employs.

We welcome recent FOS initiatives to publicise more material explaining how some cases are treated and shedding more light in on the methodologies adopted. Government provision to allow the FOS to publish determinations, where appropriate, may also help to make the FOS more open and responsive to all its users and stakeholders.

**Question 31: What are your views on the proposed arrangements for strengthened accountability for the FSCS, FOS and CFEB?**

We agree that there should be a requirement for the FSCS, FOS and CFEB to produce an annual plan alongside their annual budget to demonstrate how their resources will be used in the coming year. We also endorse the proposal to make these bodies subject to an audit by the National Audit Office.

**The Institute of Insurance Brokers, Higham Business Centre, Midland Road, Higham Ferrers, Northamptonshire, NN10 8DW.**

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intellect
REPRESENTING THE UK TECHNOLOGY INDUSTRY

# Intellect submission to HM Treasury

# 'A new approach to financial regulation: building a stronger system'

## April 2011

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## Executive Summary

As HM Government has set out in its recent Growth Strategy, "the private sector cannot plan for the future if it does not have confidence in the long-term stability of the economy" - the requirement for this growth strategy was, after all, a direct result of the failure of the financial system in 2008.

Since then, significant efforts have been made by regulatory authorities on a global basis to address the issues posed by the banking crisis. In the UK, HM Treasury, the Independent Commission on Banking, the Financial Services Authority, Bank of England and the Treasury Select Committee have all dedicated significant time and resource to identifying and addressing priority issues in order to reduce the possibility (and potential impact) of another crisis.

As it stands however, there is a crucial oversight in these ongoing reforms – specifically relating to systemic risk. The systems and processes for the Bank of England to collate the necessary information from Systemically Important Financial Institutions (SIFIs) that can then be used to identify the build up of risk across the whole of the financial system, are not in place.

On a UK level there is currently very little leadership on this issue and as a result the UK regulatory authorities (i.e. the Bank of England, and the Financial Policy Committee specifically) are in no better position to monitor the build up of systemic risk than they were before the financial crisis. If the next banking crisis were around the corner, the asymmetry of information between the financial service providers and regulators would be of a similar level to that in 2008 and there would, once again, be a tough choice for regulators to make as they had not been able to act sooner – i.e. to step in and bail out stricken banks, or let them fail with uncertain consequences for the rest of the economy. Therefore it is essential that regulatory authorities be given the appropriate tools to undertake its crucial financial stability role.

Tied into this, Intellect believes that if the Prudential Regulatory Authority (PRA) is to be effective in its regulatory role, it needs to ensure that the data it receives from individual financial institutions is of a suitably granular and accurate level that it can make informed regulatory decisions. As outlined above, this is currently not the case and the standard of data that is received is not of a suitable level of quality to allow the PRA or the FPC to undertake their roles effectively.

As part of the ongoing development of the prudential regulatory regime, Intellect believes that the PRA should look to establish an associated regulatory regime for ICT outsourcers in order to ensure that the authorisation process is not unduly bureaucratic, an unnecessary drain on resources (of the PRA and the organisations being inspected) and can be undertaken on a more time-economical basis – without jeopardising thoroughness.

On a high level, it is essential that all components of the proposed regulatory authorities have a greater level of technology understanding. For an industry like financial services that is built upon a fundamental platform of technology, it is critical that regulatory authorities are equipped with a full understanding of it and how its application affects business decisions and the implementation of regulation.

## 1. Intellect Financial Services Programme

Intellect is the UK trade association for the IT, telecoms and electronics industries. Our members account for over 80% of these markets and include blue-chip multinationals as well as early stage technology companies, and play a crucial role in virtually every aspect of our lives. In the UK these industries together generate around 10% of GDP and 15% of trade, directly employing over one million people.

We are a trusted partner for Government, both in terms of policy development and policy implementation across numerous sectors. We look to ensure that all relevant engagement of policymakers and regulators with industry is both easy and as valuable as possible in order that the technology industry may play the fundamental role it merits in the success of UK plc.

Intellect"s Financial Services Programme brings together over 150 suppliers of information systems, services and consultancy to the financial services sector. After the public sector, the financial services industry represents the largest market place for many of Intellect"s members. From software companies to service providers, enabling trading platforms and payment processing, technology is crucial to the sector. As such, the industry"s regulatory regime is a key issue, as, in many cases, it will be our members working with the financial institutions to ensure compliance. Global IT service providers sit alongside many specialised smaller companies and all play an active role in imparting their expertise and experience to better inform the development of financial services policy at a cross roads in the industry"s development.

Many of Intellect"s members are heavily involved in providing the fundamentally important technology platforms upon which the UK"s financial services industry is built. For example, these members help facilitate the 5.7 billion automated payments that are made through the banking system on an annual basis. Indeed, through Intellect our members are working with the Payments Council to develop the future technology that will afford consumers and businesses alike more convenient, secure and efficient ways to conduct their transactions. Similarly, the 40 million online bank accounts that are registered in the UK would not function without the technological capability that our members design and supply.

http://www.intellectuk.org/content/view/23/3/

## 2. Chapter 2 – Bank of England & the Financial Policy Committee

**Question 2 – Are there any other potential macro-prudential tools which you believe the interim FPC and the Government should consider?**

Intellect believes that whilst the tools that are set out in Section 2 of the consultation document are valid suggestions and should be evaluated as a means to empower the FPC to undertake its role, there is a crucial oversight in this list of tools.

Specifically, there is no mention of a **systemic risk 'early warning system'**, which would allow the FPC to collate data from individual firms and build up a picture of where risk lies across the system. As it stands, the Bank of England does not currently have the tools to undertake this role effectively and there is an assumption that the tools that are in place, are adequate. This is not the case – there is no early warning system in place to prevent the next financial crisis and this is a crucial resource that the Bank of England requires in order to fulfil its role.

As HM Treasury sets out on page 3 of this consultation „The crisis was caused by the failure...of regulators to spot the risks that were building up across the system as a whole‟. It is common sense therefore that the FPC is given the tools to spot risks, before it is too late to act. Currently such a system is being assessed for development by the Office of Financial Research (OFR) in the United States - a product of the recent Dodd-Frank Act but the regulatory authorities in the UK have not, as yet, acknowledged.

Three years on from the onset of the financial crisis and the systems and processes for the Bank of England to collate the necessary information from Systemically Important Financial Institutions (SIFIs) that can then be used to identify the build up of risk across the whole of the financial system, are not in place. This is despite the technology being available to establish such a „system‟. Equally worrying, there appears to be no acknowledgement amongst regulators of the requirement to put such a system in place, which is a direct result of a lack of understanding of the means to do so.

Indeed, up until the recent publication of HM Treasury‟s proposals for the regulatory system („A new approach to financial regulation: judgement, focus and stability‟) on the 17th February, there was no one body taking ownership of this issue. Now the Interim FPC will have responsibility for monitoring systemic risk but, as it stands, does not have the ability to do so and there appears to be an assumption amongst regulators and policy makers that such a system is already in place. It is not.

Whilst Intellect appreciates that the FPC‟s macro-prudential „toolkit‟ will be established through secondary legislation, we also believe that it is critical that such an important part of this toolkit is recognised by HM Treasury and the Interim FPC now, before the FPC takes office officially and it becomes clear that it lacks the tools to identify and mitigate the build up of systemic risk across the financial system.

Intellect therefore believes that, for the good of the financial system, there needs to be a concerted evaluation by the Bank of England of the sort of information it needs to collate in order for it to identify risks that are building up across the financial system. A systemic risk „early warning system‟, entrenched in the legislation required to enact the new regulatory system, can then be developed by both industry and the regulators. Such as the system is already being assessed for development by the OFR in the United States (a product of the recent Dodd-Frank Bill). The creation of the European Systemic Risk Board (ESRB) is also indicative of the importance that the European Central Bank (ECB) is attaching to this issue in terms of maintaining financial stability across the Euro zone.

Whilst Intellect is the trade association for the UK technology industry, this is not necessarily a technology issue. Instead, monitoring systemic risk is about setting appropriate standards and oversight for a stable financial system. What is lacking is therefore twofold:

- Consideration of this issue alongside other „big ticket‟ regulatory reform issues such as capital and liquidity requirements; and the potential „retail ring fencing‟ measures being considered by the Independent Commission on Banking . The impact that the lack of such a system prior to the financial crisis and the impact that another financial crisis would have on the UK economy makes this a political and regulatory priority.

- A mandate, preferably from HM Treasury or the Bank of England, to build a set of standards and processes that can help identify risk right across the financial system.

**Systemic risk – the current situation in the UK**

On a systemic level, the financial crisis exposed the weakness of the UK‟s and US‟s financial services regulatory framework and in particular the asymmetry of information between the regulators and financial services providers. HM Treasury and regulators across the global financial system have already stated this was a major contributing factor to the financial crisis.

The result was that the prudential regulatory system was not equipped to manage systemic risk. The information gap between the tripartite regulatory authorities and the financial institutions slowed the response to the financial crisis. Whilst the Government was able to step in and save RBS and HBOS, albeit at a high cost, this was undertaken without full knowledge of the risks that the banks faced, and an accurate, holistic assessment of what risk their collapse would have posed to the financial system as a whole.

In the U.S. where the regulatory system suffered from the same deficiencies, a slowed response time meant that the authorities could only act to save one of Lehman Brothers or AIG, and the rest is history.

The problem stems from the fact that the data that regulatory authorities currently have access to from financial services providers is neither in a uniform standard (making it much harder to collect, compare and analyse what the data means) nor is it granular enough. I.e. this data is not of a sufficient standard to allow regulators to paint an accurate picture of the realities of the positions of individual SIFIs, and in doing so, of the financial system. There has been only one bank in the UK that has applied significant time and resource to transforming its internal processes and data collection so that it can report into regulators accurately. The rest have not. This lack of „a single source of truth‟ from each of these individual SIFIs presents a significant challenge for the FPC – i.e. how can it determine where the risk is across the financial system and act to mitigate it, if accurate information about risk in individual financial institutions cannot be determined.

The complexity of the global financial services industry and the products within it have themselves provided something of an opacity which is directly responsible for complicating the task of viewing the whole of the financial services system, and assessing risk therein. There is currently very little motivation for financial services institutions to reduce this opacity as a lack of transparency is conducive to the development of complex and profitable products. In short, it is good for business.

Other sectors, such as pharma, aerospace and the chemicals industry have all increased their own transparency through regulator-enforced modernisation – i.e. standardising the flows of data from individual companies to regulators. It is no surprise that as transparency of a specific industry is increased, the effectiveness of that specific regulator increases as well. If industries such as this can modernise, there is a strong argument for an industry as economically and socially critical as the financial services industry, to modernise as well. The financial services industry is also capable of the same modernisation of its data flows (precisely what is required for a systemic risk „system‟), despite its protestations – this capability is already demonstrated on a daily basis through the vast amounts of trade data that is channelled at great speed between institutions operating in the capital markets (high frequency trading is a notable example).

**Implementing an early warning system – UK is lagging behind**

In the United States the OFR has been established within the US Treasury Department as a result of the Dodd-Frank Bill. Its remit is to improve the quality of financial data available to policymakers and facilitate more robust and sophisticated analysis of the financial system. In effect, the OFR is permitted by law to demand data from financial companies including banks, hedge funds, private-equity firms and brokerages. It would be able to track information such as counterparties for credit-default swaps and would, crucially, afford regulators the sort of system-wide overview (including darker parts of the market) that will allow it identify when and where there is a risk to financial stability. The OFR also has the authority to set out new legislation based upon its findings. All this, and the fact that the OFR has recently started defining reporting standards for

the financial community puts it way ahead of the Financial Policy Committee in terms of establishing tools to head off the next financial crisis.

On a European level the ESRB was established, again by law, in December 2010 under the auspices of the European Central Bank and has a similar function to the OFR. Whilst it is not yet as advanced as the OFR in terms of its use of data, it is also still way ahead of the UK as it has acknowledged that data standards that will allow it to collate information from 75 different member organisations (including the ECB, the EU national central banks and EU national regulatory authorities amongst others) are not sufficient to allow it to undertake its role effectively.

That both these institutions have acknowledged that current data standards are insufficient to afford regulators the necessary systemic risk early warning systems should, Intellect believes, be heeded by the Bank of England and acted upon now, whilst the regulatory system is being reformed.

**What would a systemic risk early warning system look like?**

In order to carry out its role of maintaining financial stability by monitoring systemic risk and stepping in to mitigate where necessary, the Bank of England will need to implement an overarching „systemic risk utility" that will collate information from individual financial institutions and present it in a way that it can be analysed and interpreted by the FPC. It is envisaged that, ultimately, the front end of this system could represent a „dashboard" that could inform and alert the Bank of England to the build up of systemic risk, in a timely manner and in a way that could enable to it to step in and set a requirement for specific actions on individual banks.

Advances in computing power, data storage and analytical techniques mean that the creation of this utility for the entire financial system is now a viable proposition. Systemic risk (macro) analytics aim to quantify risks relating to the broad-scope, long-term dynamics and dependencies of major markets and players, and are associated with significant shifts in market state. By contrast, market and credit risk (micro) analytics have a narrower scope, make linear extrapolations from recent market trends, and assume localised shifts in aggregated market parameters.

Such a system would require the following components:

Reference Data (including standard legal entity identifiers)

- A means to gather, cleanse, organize public reference data for end to end cash flow risk analysis

„System of Systems" Approach

- Reuse of existing components in an open and extensible architecture

Collaborative Analytics

- Establish a secure, collaborative analytic tooling for risk valuations and analytics across the financial system

Data-driven Stress Tests and Interventions

- Support for stress-testing and targeted intervention driven by actual position and counterparty data

However, it is worth noting that the burden of resourcing this „system of systems" should not fall wholly on the Bank of England. It is the collection and use of non-standardised data within individual financial institutions that poses the fundamental challenge in detecting and mitigating the build up of systemic risk and which made it near impossible for the regulatory authorities to identify risk signposts in the lead up to the recent financial crisis and intervene before it became necessary to bail out financial institutions.

Therefore it is envisaged that the bulk of the cost of such a system should be borne by the financial services industry, who dedicate millions of pounds per year into developing commercially orientated low latency IT

systems that contribute significantly to their performance in financial markets and have significant profit making capabilities.

As a result of such a system, the entire financial industry will benefit from central provision of clean reference Data, instead of the current situation with each enterprise having to cleanse and maintain its own. This could save the industry millions of pounds per annum as well as reducing the chances of bank failure and increasing market certainty.

**In the short term...**

Measuring systemic risk will be an iterative and a multi-year effort, however pragmatic steps can be taken to start now. Initially better data management can help consolidate existing data and systems for better analysis and insight, and will define the minimum set of data standards and reporting requirements to allow cross-firm and cross-market analysis.

Data models can be developed to analyse data gaps currently impeding systemic risk measurement, to aggregate and link data across a large number of financial institutions and markets, identify important data that is currently inaccessible, and define consistent data „tags and identifiers" for securities attributes and legal entities. Alongside the models, data analytics will measure different dimensions of systemic risk to develop automated processes for continual stress testing, standardise approaches for gathering normalised data from multiple institutions, and develop forensic and „what if" scenarios and simulations. Overall this will enable the development of macro prudential regulatory and systemic risk tools that can run scenarios and simulation techniques to further support the transparent monitoring of the financial system.

The risk is that policy makers and regulators will choose not to address this system early enough and will treat it as an afterthought.

As set out in the Impact Assessment within HM Treasury"s consultation, the Bank of England will not be inheriting or utilising the FSA"s existing IT system and will be looking at its own systems that can perform the tasks that it has been created to perform. This would therefore be the correct juncture for the FPC to consider what sort of data it requires from individual banks, so that it can integrate this into its eider technology requirements.

## 3. Chapter 3 – The Prudential Regulatory Authority

**Question 7 – What are your views on the mechanisms proposed to make the regulator judgement-led, particularly regarding: rule making; authorisation; approved persons; and enforcement (including hearing appeals against some decisions on a more limited grounds for appeal?)**

**Technology expertise of the PRA**

On a high level, if the PRA is to be able to investigate and tackle risks/vulnerabilities in individual firms, it must understand how the systems within each firm works, and how changing them can tackle existing risks, but also create new ones. For an industry like financial services that is built upon a platform of technology, it is critical that regulatory authorities are equipped with a full understanding of technology and how its application affects business decisions and the implementation of regulation.

In the case of the PRA, it will be almost impossible for it to set lasting „rules" effectively, exercise judgement over authorisation issues and, on a wider level, lead on prudential regulatory issues if it does not have a detailed understanding of the technology that not only underpins existing banking institutions, but which drives changes to financial providers" operations and strategies.

If the current regulatory focus on the financial services industry is about ensuring that no more avoidable crises befall it; that consumers are adequately protected; yet ensuring the City remains competitive on a global scale and able to contribute to the UK‟s economy, there needs to be 360 degree consideration of all relevant issues and factors. Regulation and judgements not only need to reflect how technology can facilitate better policy today, but also what technology will empower the financial services industry to do for its customers, investors and the economy tomorrow.

Given the failures of the FSA during the banking crisis, Intellect believes is an opportunity for the PRA (and the Financial Conduct Authority) to learn from the FSA‟s shortcomings and integrate an understanding of the operational realities of the financial system into its every day activity.

**Changes to regulatory reporting standards**

Intellect believes that if the PRA is to be effective in its regulatory role, it needs to ensure that the data it receives from individual financial institutions is of a suitably granular and accurate level that it can make informed regulatory decisions. As outlined above, this is currently not the case and the standard of data that is received does not represent an accurate assessment of, for instance, the risk held by individual financial services providers. This deficiency is not appreciated by the current regulatory authorities.

Therefore, the PRA should take measures to ensure that individual financial services providers undertake the wholesale transformation necessary to deliver this critical standard of regulatory reporting data. Currently there is only one bank that has undertaken wholesale changes to create a single source of the truth that can be used for both prudential and regulatory reporting. One bank out of the „big four‟ does not suggest that the financial system is moving towards greater stability.

On a systemic level, if the PRA cannot extract more accurate and simplified data from individual banks, the FPC will not be able to undertake its own financial stability role. This point is set out in more detail in Section 2 – above. A solution may be that the PRA has to take steps to:

- **Ensure a common data standard is adopted by all financial institutions**
  To allow the PRA to make comparisons across financial services providers, and for the FPC to be able to more easily compare information taken from SIFIs to identify and mitigate the build up of systemic risk, the collection of data needs to be in the same format. The PRA should take steps to ensure that all banks undertake the systems transformation required to deliver a common data standard.

  An option to achieve this could be Extensible Business Reporting Language (XBRL) which is a freely available and proven global standard for financial reporting and can be extended to risk management in the proposed new regulatory environment. Regulatory authorities are already playing a key role in the business reporting process, so this standard should not be new to them.

  XBRL can help define systemic risk taxonomy and give regulators the ability to extend their analysis of a financial institution‟s balance sheet. This will provide them with a window for identifying large exposures across firms and markets that are increasing leverage and counterparty risks. XBRL-driven collection of risk data can help regulators monitor and act more decisively during periods of financial distress. Stronger information standards and data aggregation will help regulators move to a state of situational governance in which they can manage too-important-to-fail scenarios more effectively.

- **Facilitate greater standards of data analysis at a regulatory level**
  In order for the PRA to achieve its own oversight objectives it needs to be able to model macroeconomic impacts, evaluate systematic risk, and perform banking book and credit risk analysis. This analysis needs to be performed at a Financial Statement level on one or many financial institutions, or at an aggregated level on portfolios. This modelling capability needs to be flexible, analyst driven (not fully reliant on IT systems and processes), and should avoid replication of all the detailed data held in a financial institution.

**Regulatory regime for technology providers**

As part of the ongoing development of the prudential regulatory regime, Intellect believes that the PRA should look to establish an associated regulatory regime for ICT outsourcers in order to ensure that the authorisation process is not unduly bureaucratic, an unnecessary drain on resources (on the PRA and the organisations being inspected) and can be undertaken on a more time-economical basis – without jeopardising thoroughness.

This could take the form of a set of clear handbook-style requirements and compliance guidelines that could, in the same way as the existing FSA handbook – provide guidance to ICT outsourcers and which would be both necessary and sufficient for the provider to achieve the associated regulatory approval.

This would ensure that suppliers did not have to accompany each contract negotiation with the same evidencing of capability, information security and business continuity planning. Such a scheme could be flexible to account for the scale of both provider and customer, the level of transfer of responsibility (e.g. ownership of infrastructure ,etc..) and the risks associated with the customer‟s regulated activities (e.g. execution-only institutional broker vs retail bank).

Ultimately, the complexity of the authorisation process under the FSA has acted as something of a barrier to many technology providers supplying services to new entrants. Current outsourcing authorisation processes could eventually have the effect of discouraging smaller ICT providers from forming commercial relationships with prospective and new entrants to the financial services sector. It is simply not as profitable for smaller ICT providers to be involved in such projects as it would be for them to be involved in other, less scrutinised markets. Intellect believes (and has submitted consultation responses to the Office of Fair Trading, HM Treasury and the Treasury Select Committee to this end) that innovative IT-enabled customer services and Infrastructure are important to new entrants‟ entry and expansion in order to differentiate themselves from incumbents. A reduced field of suppliers to choose from will harm this ability and will ultimately harm the integrity of the market and choice for consumers. The public sector has, in recent years, seen a similar problem where smaller, innovative suppliers were discouraged from tendering for government contracts because of the costs of embarking on a time consuming and administration-heavy process. There is a danger that through increased regulatory scrutiny of ICT suppliers, the financial services industry could be sleep walking into a similar situation.

Whilst Intellect appreciates that competition is not an issue specifically within the remit of the PRA, this is an instance where the approach that the PRA takes to its authorisation remit, will have an effect upon the remit of the Financial Conduct Authority, i.e.-

- Acting as a potential obstacle to new entrants to the financial services (esp. Retail banking) sector
- Leading to a reduction in the ability of financial services companies to provide innovative, technology enabled products for consumers or to allow them to provide services that reflect the changing (increasing technology-focused) demands of customers

Intellect would be happy to work with the PRA to define what this regulatory guidance might look like in practice.

## 4. Chapter 4 – The Financial Conduct Authority

**Question 11 – What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the FCA**

As is the case with the PRA, if the FCA is to discharge its objectives effectively, it is essential that it understands how individual bank‟s operations run and how this affects the service that is delivered to the consumer.

Issues such as lack of consumer choice, high charges for credit and barriers to entry for new market entrants to the financial services industry can all be mitigated by the correct application of technology. It is important therefore that if the FCA is able to protect consumers and ensure market integrity, it has a detailed understanding of the role that technology can, and indeed is, already playing in this sphere. On the other side of the equation, it is equally important that the FCA has an understanding of technology within financial services so that it can identify when, directly or indirectly, it contributes to risk to consumers and the market.

Intellect"s response to the Office of Fair Trading"s review of *'Barriers to Entry, Exit and Expansion in Retail Banking'*[1] outlines these issues in detail, but in summary the FCA needs to have the resources in place, or the links to industry expertise such as Intellect, so that it can develop an understanding of the following issues.

- **Increasing flows of capital to SMEs** – by improving the collation and sharing of credit risk information on SMEs between banks, more informed decisions can be made on lending to a sector that banks have largely treated as a commercial risk. Technology has a critical role in facilitating this sharing of data and as such, has a critical role to play in facilitating the UK"s economic recovery

- **Increasing competition within the banking sector** – by reducing customer inertia through the development and provision of individual, transferable bank account numbers; the provision of customer-focused technology-enabled products; and reducing start-up costs for new entrants

- **Improving customer service –** There are currently issues surrounding the ability of banks to retire products that are unprofitable and exit these specific markets, and also in terms of delivering products that are suitable for individual consumers. The application of technology is both the problem and the solution in this instance and is an example of how the FCA could perform its function more effectively with a strong understanding of the technology issues therein.

## Conclusions

Whilst the proposals that HM Treasury has put forward in its latest paper are of course welcome, Intellect does believe that there are some very important omissions from the document and would urge it to consider the issues set out in this paper as a matter or urgency.

Intellect fully supports the case HM Treasury has put forward for equipping the FPC with the tools it requires to ensure financial stability – by identifying and mitigating the build up of systemic risk across the financial system. However HM Treasury has not yet addressed the issues that are already being addressed in the U.S. – specifically how to mandate and build a systemic risk early warning system. The establishment of the OFR in the U.S. with the remit to examine how data can be drawn from financial services providers across the system puts the U.S. at an advantage to the City and puts the US financial system ahead o f the UK in terms of its approach to reducing systemic risk. To assume that the system to measure and monitor systemic risk is sufficient is both erroneous and dangerous. There has been little improvement in the means for banks to collate more accurate information for risk reporting over the past 3 years since the banking crisis. Similarly there has not been, as yet, an assessment of the quality and type of data that the FPC will require from the banks in order to effectively undertake their role of monitoring and mitigating the build up of systemic risk. The very fact that the regulators currently hold the same tools to spot the next banking crisis as were held in 2008, is very worrying and something that HM Treasury should be addressing as a matter of urgency.

Yes, it is important for banks to build up adequate capital reserves so they can survive future market shocks, but without an adequate means to spot where this next shock might come from and when it might happen, the regulatory authorities are missing a very important financial stability tool. The US regulatory authorities

[1] Intellect submission, 'Barriers to Entry, Expansion and Exit in Retail Banking', July 2010

http://www.intellectuk.org/component/option,com_docman/task,doc_download/gid,4496/Itemid,102/

have realised this and it is time that the UK authorities did likewise.

As it stands there has been little to no assessment of this issue by regulators – largely because it is not currently a „political issue" but this does not make it any less important.

HM Treasury should now be asking the question – „can we afford to bail out banks again should we fail to spot the next banking crisis and are we confident that the tools we have are enough to spot the next crisis, especially as other regulatory authorities are beginning to accept they need a systemic risk early warning system?" It might also want to ask the question – „how were we meant to identify the next banking crisis when the tools that the regulators have to do so have not been changed since the previous failure to spot a banking crisis?"

Essentially the solution lies in the quality of data coming from banks. This needs to be improved – the quality was not of a suitable quality during the last banking crisis and little has changed since. Yet the banks will not do this on their own volition. The opacity of the system is good for business and if there is to be change, there needs to be a mandate from Government so the FPC can receive the quality of risk information it requires to undertake its role.

The application of technology within the financial services system is not a new phenomenon – the financial system has been built upon fundamental technology platforms for over two decades and this trend is only going to become more acute. It is the responsibility of all elements of regulatory authorities to ensure that their understanding of this technology, how it works and how its application affects business decisions is improved. It is important for the success and effectiveness of these regulatory authorities that they do not adopt the same attitude as the FSA has had on this issue – i.e. to treat as technology as an implementory after thought, rather than an operational reality that influences all aspects of the financial system.

## Contact

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ICMA

Financial Regulation Strategy
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

*(by e-mail to financial.reform@hmtreasury.gsi.gov.uk)*

14 April 2011

Dear Sirs,

**HMT consultation cm8012: "A new approach to financial regulation: building a stronger system"**

The International Capital Market Association ("ICMA") is responding to HM Treasury's above consultation.

ICMA is a unique self regulatory organisation and an influential voice for the global capital market. It represents a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges, central banks, law firms and other professional advisers. ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years. See: www.icmagroup.org.

ICMA is responding in relation to its primary market constituency that lead-manages syndicated bond issues throughout Europe. This constituency deliberates principally through ICMA's Primary Market Practices Sub-committee[1], which gathers the heads and senior members of the syndicate desks of 23 ICMA member banks, and ICMA's Legal and Documentation Sub-committee[2], which gathers the heads and senior members of the legal transaction management teams of 19 ICMA member banks, in each case active in lead-managing syndicated bond issues in Europe.

We set out our response in the Annex to this letter and would be pleased to discuss them with you at your convenience.

Yours faithfully,

**Ruari Ewing**
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[1] http://www.icmagroup.org/About-ICMA/ICMAs-Committees/Primary-Market-Practices-Sub-committee.aspx.
[2] http://www.icmagroup.org/About-ICMA/ICMAs-Committees/Legal-and-Documentation-Sub-committee.aspx.

## Annex

ICMA is focusing here on the role of the UK Listing Authority (**UKLA**) within the future Financial Conduct Authority (**FCA**) and is responding to questions 11 and 16 (second bullet) only.

***11. What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the FCA?***

***16. The Government would welcomes specific comments on:***
***- [...]; and***
***- the proposals in relation to listing and primary market regulation.***

The proposed statutory objectives for the FCA seem generally suitable. However there is potential for contradiction between them: the strategic objective "protecting [...] the UK financial system" (and the operational objective of "protection for consumers") could be interpreted to require financial risk to be reduced to a minimum, which will consequently reduce "choice in the market for financial services" and so adversely impact that operational objective – some statutory acknowledgment that the FCA should sensibly balance the objectives in different contexts seems necessary. We believe that the UKLA should not be forced, in an attempt to achieve this balance, into refusing admission of riskier securities to the UK's markets. Rather, it should continue to seek to attract to the UK's markets as wide a range of issuers and products as possible, thus maintaining the UK's position as one of the world's leading international financial centres. The knowledge of markets and products gained through this process will provide an extremely valuable source of information for the market conduct and prudential supervision elements of the new regulatory structure; and, of course, consumers will still be protected through appropriate conduct of business rules.

There is a further danger in the UKLA becoming more restrictive in its approach due to its being subject to the same obligation and regulatory approach as the rest of the FCA. This is the risk that UK-based investors, in their search for higher yields, will increasingly buy riskier securities listed outside the UK, in jurisdictions where there is no similar approach to product regulation (see further below) and a more basic approach to the disclosure required in the listing context – effectively leaving UK-based investors (as well as others) with potentially less (or reduced quality) information on which to base their investment decisions. In this respect, keeping some focus (notably in the form of an operational objective) on the competitiveness of the UK's financial markets would be beneficial from a systemic financial stability perspective.

There is also a risk of confusing markets regulation with retail protection regulation – two very distinct responsibilities. In particular, it seems misleading to use the term 'consumer' (directly equated in most peoples' mind with retail investors) "defined broadly to include persons who use, have used or may use "services" or have relevant rights or interests in relation to those services, and persons who have invested in, or may invest in, securities (for example, those listed on the Official List)". The term "market user" would seem more appropriate.

More generally, ICMA is aware of increased Financial Services Authority (**FSA**) interest in product regulation (most notably in the context of its Discussion Paper DP11/1 on product intervention[3]). The regulator should always be wary about the risk of being seen (most likely with hindsight) to endorse certain products. No product will appropriate to all users in all circumstances and this should be, and is, rightly regulated for retail investors / consumers as part of the selling process under the conduct of business regime (with more sophisticated investors being allowed to judge risks and returns for themselves). However, we fear that the power to intervene in relation to particular products early in their development cycle, combined with the declared intention of the FCA to adopt a more intrusive approach, may be seen by many as equivalent to product endorsement, non-intervention being taken as approval. This problem will become particularly acute when there is a market failure, with significant numbers of investors losing money on a particular type of product.

[3] See http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf.

On a related vein, the consultation picks up on wholesale activities flowing through to retail financial services as part of a transaction chain. Here again, explaining to retail investors / consumers the risks associated with products should be, and is, rightly regulated for retail investors / consumers as part of the selling process under the conduct of business regimes. The only distinction from a listing perspective, should follow that between the EU Prospectus Directive's retail (sub-€50,000 denominations) and wholesale (€50,000 and above denominations) regimes.

A great asset of the UKLA currently is its ability to draw upon the granular knowledge of its prudential supervisor colleagues, many of which (particularly those responsible for the more relevant issuers) will become part of the distinct Prudential Regulation Authority (**PRA**). The Consultation envisages cooperation between the FCA and PRA, but this is non-specific except at the senior and formal levels. The UKLA should not be seen to be approving prospectuses on the basis of information that it may no longer have access to. However, it will still be important that, when a regulated institution such as a bank raises additional capital, the prospectus continues to be reviewed by the issuer's prudential regulators. One potential approach might be for draft prospectuses to be reviewed in terms of factual completeness by the relevant PRA supervisory staff – this would need to be carefully coordinated to ensure that overall review timetables (such as those specified in the EU Prospectus Directive) are not adversely impacted.

Whilst the underlying nuances discussed above may seem clear to current HM Treasury and FSA staff currently working on the development of the UK's new approach to financial regulation (and so not in need of clarification), this will not necessarily be the case for other or future (and possibly more junior) FCA staff actually involved in the day to day discharge of the FCA's statutory responsibilities – hence the need to include specific provisions in the relevant legislation.

**IUA RESPONSE**
**TO THE HMT CONSULTATION ON FINANCIAL REGULATION**

14 April 2011

Financial Regulation Strategy
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

***EMAIL RESPONSE***

**Consultation on financial regulation: building a stronger system**

Thank you for inviting comments on the HMT Consultation on financial regulation: building a stronger system.

The International Underwriting Association (IUA) represents insurance and reinsurance companies in the international insurance and reinsurance market working in and through London. Our membership, consisting of 41 general insurers and reinsurers, makes up approximately 95% of the London insurance company market.

**FPC**

*Q 3. Do you have any general comments on the proposed role, governance and accountability mechanisms of the FPC? Please see pages 30 – 35*

Answer We are pleased to note that the consultation document (para 3.21) recognises that insurance has a very different business model from other financial services. Banking is vulnerable to panic withdrawals and contagion because it relies on leveraging, on inter-institutional exposure and on borrowing short to lend long. The business of insurance and reinsurance, on the other hand is not a source of systemic risk, because regulated insurers and reinsurers are not comparably exposed to each other and their customers provide their funds in advance and cannot call on them until they make a claim. As a result, the main focus of the FPC will inevitably be banking and not insurance or reinsurance. Nevertheless, given its powers of recommendation and direction, we believe it will be necessary to avoid situations where the highly banking-oriented leadership of the FPC unwittingly makes false assumptions about insurance and reinsurance. We are, consequently, also pleased to note that Paragraph 2.78 indicates that it will be important that the five external members of the FPC should be able to offer insights from direct experience not only of banking, but also of insurance and other financial services. We believe, however, that, for the sake of balance, some of the six Bank of England members of the FPC should also be able to draw on such direct experience. We also believe that direct experience must include practical experience of working in the insurance business and not restricted to non-executive participation. The

FPC needs to be intimately familiar with the distinct activities of life assurance, of non-life insurance, of retail insurance and of the wholesale trade of the London Market. In addition, while academics and civil servants may bring valuable understanding, actual experience of working for the industry as an employee or a consultant will contribute invaluable insights, so senior figures from different parts of the insurance industry should be represented.

We welcome the intention of the Treasury Select Committee to exercise more active scrutiny than has been the case under previous regimes. We believe independent external oversight will be necessary, not only in relation to the efficient achievement of the objectives of the FPC the PRA and the FCA, but also in relation to the protection of the interests and rights of the regulated entities in relation to potential maladministration or abuse of power. In our view, the arrangements for dealing with complaints set out in paragraphs 3.60 to 3.62 and 4.40 will be helpful, but it will be difficult to ensure that external persons appointed to deal with complaints will be fully independent or will be vested with sufficient authority or resources fully to meet the requirements of the role. As for judicial review, the processes are so lengthy and involved and so difficult to invoke that they do not provide an adequate or appropriate recourse for responding to potential maladministration or abuse of power. We would therefore recommend that there should in addition be a right of appeal to a higher appellate body.

*Q 4. Do you have any comments on the proposals for the regulation of systemically important infrastructure? Please see pages 38 – 41.*

Answer We note that the insurance industry infrastructure is excluded from what the document recognises as systemically important infrastructure. In the light of our response to Question 3, that appears appropriate.

**PRA**

*Q 5. What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the PRA? Please see pages 45 – 48.*

Answer We agree with the arguments advanced that:

- financial stability and soundness of firms must be promoted
- firms must be allowed to fail; and
- senior management should be subject to approval.

It is also essential that the regime should be carefully designed to be proportionate and reasonable and that the procedures should be fair, transparent and speedy, without imposing impractical deadlines and requirements.

It is a matter for concern to us that the PRA will not be required to have regard for diversity, innovation and competitiveness. The financial services industry in the UK, not least the London Insurance Market, plays an essential role in maintaining the financial well-being of the British economy (as indeed is recognised in paragraph 4.104). While we recognise that the banking sector was largely responsible for the financial crisis and needs to be subject to systemic controls and supervision, there can be no doubt that the recovery of the economy in the UK will depend on a resurgent financial services industry. In the longer term, it may well be important to rebuild other pillars, such as

manufacturing and engineering, but in the meantime, the emergence of new world markets means that there are significant opportunities for growth in financial services and the UK remains uniquely well prepared to take advantage of them. At the same time, other centres are poised to gain as much business as they can. Effective regulation focused on financial stability will contribute to a more competitive market, but a more holistic and proactive approach is required. It would be unfortunate if public concern about financial stability were to threaten the future finances of the UK economy by dampening support for competitiveness and diversity. As for innovation, it is evident that esoteric modelling of securities and trades was passed off by some institutions as a form of innovation and contributed significantly to the financial crisis. Nevertheless, innovation in the true sense of novel means of adding value, of meeting demand and increasing efficiency is the lifeblood of successful business and is certainly what has given the London Insurance Market its traditional edge on its competition. Moreover, we believe that a duty for the regulator to have regard for competitiveness and innovation would not distract it from its principal mission of ensuring policyholder protection and financial stability. On the contrary, it would encourage macro-economic and forward thinking, while also discouraging a rigid and unimaginative rules-based approach that ignores the wider and longer-term picture.

*Q 6. What are your views on the scope proposed for the PRA, including Lloyd's, and the allocation mechanism and procedural safeguards for firms conducting the 'dealing in investments as principal' regulated activity? Please see pages 48 – 50.*

<u>Answer</u> Given the importance of solvency and prudential matters in the business of general insurance, we believe that within the proposed new arrangements the PRA should have primacy in the regulation of general insurance. Solvency II provides a comprehensive framework that links together capital adequacy, risk management, governance, reporting and disclosure. It is difficult to envisage how two separate bodies could administer such a complex and interconnected regulatory structure and, clearly, it is the PRA that will be best equipped to fulfil the role.

Paragraph 3.22 indicates that the Bank of England and the FSA need to consider how the characteristics of insurance firms should be recognised appropriately within the regulatory framework. While the language of the paragraph clearly relates primarily to life assurance, we presume that it is also intended to refer to general insurance. We look forward to the consultation that will arise from the deliberations between the two bodies.

*Q 7. What are your views on the mechanisms proposed to make the regulator judgement-led, particularly regarding: rule-making; authorisation; approved persons; and enforcement (including hearing appeals against some decisions on more limited grounds for appeal)? Please see pages 50 – 51.*

<u>Answer</u> We agree that the PRA approach should be principles- and judgement-based, but that it must be proportionate, reasonable and fair. It will, as suggested, be helpful for the PRA to provide short statements explaining the rationale behind each of its rules.

We believe that the full merits review process should be maintained for firms subject to enforcement. Please also see the second paragraph of our response to Question 3.

The stages and key elements in the proposed Proactive Intervention Framework (page 51) are already present in Solvency II. Duplication of processes from parallel sets of requirements should be avoided. We suggest that the PIF, if introduced for insurance, should simply be subsumed into the existing Solvency II arrangements.

*Q 8. What are your views on the proposed governance framework for the PRA and its relationship with the Bank of England? Please see pages 51 – 54.*

Answer We agree that the PRA should be operationally independent and that there should be free flow of information between the senior management of the PRA and the BoE and, when the need arises, shared understanding of the possibility of failure.

Q 9. *What are your views on the accountability mechanisms proposed for the PRA? Please see pages 54 – 56.*

Answer We agree that the Treasury should exercise powers to verify that the sharing of information and understanding between the PRA and the Bank of England is functioning as intended. In addition, we suggest that the Treasury should also be required to verify that relationships do not become too cosy and complacent.

Auditing by the National Audit Office also appears to be an effective safeguard.

Furthermore, we agree that the PRA should maintain a complaints procedure on the same lines as the FSA and that there should be independent scrutiny of the complaints procedure. However, please see the second paragraph of our response to Question 3.

*Q 10. What are your views on the Government's proposed mechanisms for the PRA's engagement with industry and the wider public? Please see pages 56 – 58.*

Answer We agree that there should be no significant reductions in requirements for the PRA to consult industry, including an equivalent of the Practitioner Panel and annual consultation.

We also agree that there is no need for the PRA to have a Consumer Panel.

**FCA**

*Q 11. What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the FCA? Please see pages 61 – 65.*

Answer We agree that the FCA should seek to promote competition and remove regulatory barriers.

We also agree that the regulator should act with transparency

*Q 12. What are your views on the Government's proposed arrangements for governance and accountability of the FCA? Please see pages 66 – 67.*

Please see the second paragraph of our response to Question 3 and our response to Question 9.

*Q 13. What are your views on the proposed new FCA product intervention power? Please see pages 70 – 71.*

Answer We do not believe that the regulator needs new powers to make temporary product intervention rules for general insurance products. Adequate powers exist already in the existing framework and it should be sufficient that they be exercised efficiently and proportionately. The serious problems that arose with PPI were not so much to do with the product as with the way in which it was sold by credit institutions and the consultation document offers no other reasons or examples illustrating why the regulator might need new powers to intervene in the general insurance market. Consequently, we also do not agree that the regulator should have new powers "to make provision on the unenforceability of contracts made in breach of product intervention". Moreover, it would be unfeasible and wholly disproportionate for general insurers to clear retail products in advance with the regulator. For large risks and reinsurance business, it would be impossible. The effect of such requirements would be that competition and diversity of offer would be severely hampered while the cost of selling general insurance and of regulating it would rise considerably. The traditionally free UK general insurance market would suffer considerably with huge detriment to the customer. In addition, in our view the regulation of reinsurance and large-risks products should best be undertaken by the prudential regulator which would be more suitably placed to understand the nature of the product and the risks attaching to the insurer and the customer.

*Q 17. What are your views on the mechanisms and processes proposed to support effective coordination between the PRA and the FCA? Please see pages 81 – 84.*

Answer We agree that the proposed statutory duty to coordinate the functions of the PRA and the FCA is essential. In our view, it will be very important that the activities of the two bodies should be thoroughly integrated to avoid duplication, unnecessary bureaucracy and costs to the industry and to the regulators (also at the expense of the industry). As noted in our response to Question 6, Solvency II provides a comprehensive framework that links together capital adequacy, risk management, governance, reporting and disclosure. It is difficult to envisage how two separate bodies could administer such a complex and interconnected regulatory structure and it would be best if the PRA fulfilled all the relevant regulatory functions. The proposal that the two bodies should be required to have regard for each other's statutory duties appears sound, but it would be desirable for the primary legislation to make it clear that the application of Solvency II should be a PRA function.

*Q 18. What are your views on the Government's proposal that the PRA should be able to veto an FCA taking actions that would be likely to lead to the disorderly failure of a firm or wider financial instability? Please see pages 84 – 85.*

Answer We agree that the PRA should be able to veto FCA actions that could threaten the financial stability of a firm.

*Q 19. What are your views on the proposed models for the authorisation process – which do you prefer, and why? Please see pages 86 – 88.*

Answer We believe that, for general insurance firms, the authorisation process should be handled by the PRA, taking into account the FCA guidelines. It is difficult to conceive what benefit could accrue from two authorisation processes.

*Q 20 What are your views on the proposals on variation and removal of permissions? Please see pages 86 – 88.*

Answer The withdrawal of permissions for insurers is a well-defined process already provided by Solvency II and other related legislation. It is difficult to see how it could be conducted by more than one authority, which should clearly be the PRA.

*Q 21. What are your views on the Government's proposals for the approved persons regime under the new regulatory architecture? Please see page 88.*

Answer In order to avoid duplication of effort, we believe that, for general insurance firms, the authorisation of approved person process should be handled by the PRA, taking into account the FCA guidelines and bans. As with Question 19, it is difficult to conceive what benefit could accrue from two authorisation processes.

*Q 22. What are your views on the Government's proposals on passporting? Please see page 89.*

Answer A number of London Market insurance firms are branches of European parents. Operating in the same market, we believe that it would be appropriate for them to be regulated by the same regulator as the UK-licensed firms, in other words the PRA. Notifications should also be received by the PRA. Only retail conduct of business matters, falling outside the scope of Solvency II, should be regulated by the FCA.

*Q 25. The Government would welcome specific comments on:*

*proposals to support effective group supervision by the new authorities – including the new power of direction; and*
*proposals to introduce a new power of direction over unregulated parent entities in certain circumstances? Please see pages 91 – 93.*

In our view, for insurance, these issues are already provided for adequately by Solvency II. Nevertheless, we do agree that the assets of insurance entities should be ring-fenced to protect the interests of policyholders.

*Q 26. What are your views on proposals for the new authorities' powers and coordination requirements attached to change of control applications and Part VII transfers? Please see page 93 – 95.*

Answer We agree that the PRA should be responsible for the relevant regulatory duties. The role of the insurance regulator is, in any case, already sufficiently defined by the existing legislation. It would seem unwise and unnecessary to modify the existing arrangements.

We do not believe that both authorities should be entitled to call for actuarial reports at the same time. Moreover, we do not see what benefit the FCA would derive from such a report.

*Q 27. What are your views on the Government's proposals for the new regulatory authorities' powers and roles in insolvency proceedings? Please see page 95.*

<u>Answer</u> The relevant existing legislation and processes for general insurance firms are already adequately developed and it would be difficult to change them. Consequently, we agree that the position of insurance firms must be clarified, as the proposals do not appear entirely relevant to them.

Q 28. *What are your views on the Government's proposals for the new authorities' powers in respect of fees and levies? Please see pages 96 – 97.*

<u>Answer</u> The cost of regulation to the industry is already very high. The new system will be more costly still. There will need to be strict rules about transparency, keeping costs down and timely consultation.

*Q 29. What are your views on the proposed operating model, coordination arrangements and governance for the FSCS? Please see pages 100 – 101.*

<u>Answer</u> We agree that the FSCS should be one body and that the PRA and FCA should have separate responsibilities for making compensation and fees rules. Those responsibilities should indeed be well co-ordinated.

*Q 31. What are your views on the proposed arrangements for strengthened accountability for the FSCS, FOS and CFEB? Please see pages 102 – 103.*

<u>Answer</u> We agree that FOS and FSCS should be more accountable.

**European and international issues**

*Q 32. What are your views on the proposed arrangements for international coordination outlined in the chapter? Please see pages 105 – 111.*

<u>Answer</u> We believe that the voice of the PRA must be strong in EU and international fora, either as the UK representative itself or when represented by the FCA or other UK bodies.

Nick Lowe

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ILAG

Investment & Life Assurance Group
The Practitioner Voice

Financial Regulation Strategy
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

14 April 2011

Dear Sirs,

**A new approach to financial regulation: building a stronger system.**

On behalf of ILAG, we have pleasure in responding to the above Consultation Paper.

ILAG represents members from the life assurance and wealth management industries. Its members share and develop their practical experiences and expertise, applying this practitioner knowledge to the development of their businesses, both individually and collectively, for the benefit of members and their customers.

We have a number of general comments on the consultation which are listed below. In addition our responses to the specific questions within section 3 (PRA) of the Consultation are attached.

**General comments**

We feel that the Consultation is a thoughtful and well-presented document and has some positive points;

- The clear statement that consumers have responsibilities
- The renaming of the CPMA to FCA which we hope is more than a change of name and is indicative of a change of approach
- The emphasis on effectiveness and proportionality, although it is not made clear what this will mean in practice
- The setting out of a table of principles. It will be important to establish that principles-based regulation really means that, and is not used by regulators to impose requirements by other means
- The need for regulators to discuss issues formally with Practitioner Panels and, informally, with trade bodies. Whilst it will be up to practitioners to ensure that their representations get attention there does not appear to be any formal mechanism in place to do this.
- The need to retain a consultation and cost benefit analysis regime, although we note that there is no mechanism to ensure that these are more credible than at present



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- The undertaking to consider if insurance companies need to be treated in the same way as Banks, given that so much of the financial crisis was caused by Banks

- The decision not to allow formal consumerist input to the PRA.

However, we think that the following are areas for concern and should be considered further:

- The consultation implies that the appeal against Decision Notices will be via judicial review. Does this mean that the RDC and the Tribunal will be discontinued? We feel that the problem with judicial review is that it has to be proved that no reasonable regulator could have made the decision that the regulator made, not that the decision was wrong.

- Ideally, PRA should be responsible for authorisations fees permissions and other prudential issues but a role is envisaged for FMA as well, where authorised persons will have responsibility for consumers. This may lead to confusion and duplication.

- The idea that, as far as less affluent consumers are concerned, regulators will intervene earlier than the point of sale. This raises issues of product regulation without the formal acceptance of regulators for the products which they permit.

- There is continual reference to intrusive regulation, and we question what this means in practice: is it consistent with proportionate regulation?

- FPC is supposed to prevent future financial crises but we are not told how. The proposed Memorandum of Understanding with HM Treasury may serve to inhibit the speedy decision making which might be necessary in a future crisis.

We would be happy to discuss our response in more detail.

Yours faithfully,

Mark Searle
Administration Team



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## Section 3 Prudential Regulation Authority

### ➢ The PRA's proposed objective and Regulatory Principles

***Box 3.A: Summary of proposals for the PRA's objective***
***Box 3.B: Regulatory principles to be applied to both regulators***

We note that missing from HM Treasury's list of proposals are innovation and competition, which were recommended by many respondents to the July 2010 paper, including ILAG.

### ➢ Other policy considerations

***Box 3.C - Question 5: What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the PRA?***

Whilst much can be welcomed, especially the revised *'having regards to'*, this will depend on how much effect *'having regards to'* will have in practice, especially the idea that consumers should accept responsibility for their decisions. FSA has routinely felt able to ignore the '*having regards to'* which they are subject, usually citing consumer protection.

Whilst there might be merit in the idea that regulators are not responsible for innovation, they should not actively discourage it.

### ➢ Lloyd's of London

***Box 3.D - Question 6: What are your views on the scope proposed for the PRA, including Lloyd's, and the allocation mechanism and procedural safeguards for firms conducting the 'dealing in investments as principal' regulated activity?***

The proposals seem reasonable but it is impossible to know whether the dual responsibilities would work in a crisis until one actually arises. Until then we will not really know whether the procedures for PRA to take over prudential regulation of an investment firm could operate harmoniously.

### ➢ Proactive Intervention Framework

***Box 3.E - Question 7: What are your views on the mechanisms proposed to make the regulator judgement-led, particularly regarding: rule-making; authorisation; approved persons; and enforcement (including hearing appeals against some decisions on more limited grounds for appeal)?***

Whilst principles based rule making is to be welcomed, it must be genuinely implemented and not, as sometimes presently practised by FSA, with prescription under another guise, avoiding the consultation process.

Judgment based decision making is also preferable to a routine approach but there must be some basis to the judgments which could be the subject of an appeal to a Tribunal. It would be worrying if the only appeal was to judicial review where it might be impossible to establish that no reasonable regulator could have come to the particular judgment. Pro-active intervention as a principle is impossible to argue against but it should be used very sparingly, and not routinely. Management in firms should be allowed to manage.



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- **The PRA board**

***Box 3.F - Question 8: What are your views on the proposed governance framework for the PRA and its relationship with the Bank of England?***

No comment.

- **Freedom of information**

***Box 3.G - Question 9: What are your views on the accountability mechanisms proposed for the PRA?***

No comment.

- **Annual consultation on strategy and approach**

***Box 3.H - Question 10: What are your views on the Government's proposed mechanisms for the PRA's engagement with industry and the wider public?***

Whilst much of the proposals are welcome, we feel that some FSA cost benefit analyses are not thought through and lack credibility.

Additionally, consultations must be genuine. Firms and trade bodies devote a lot of time and effort to produce reasoned and constructive responses but these often seem to be ignored. This does not encourage engagement by stakeholders.

Whilst the abolition of the Consumer Panel for PRA is to be welcomed, the role of the Practitioner Panel should also be reviewed. Currently, FSA seems able to disregard its recommendations. This may be because the process is not open and the process may be improved if its recommendations and PRA's responses to them were made public. The Panel could publish material on its own initiative, as the Consumer Panel currently is quite happy to do.

*Ends*



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14 April 2011

Emil Levendoglu
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Emil,

**A New Approach to Financial Regulation**

The Investment Management Association (IMA) thanks you for the opportunity to comment on the above paper.

The IMA represents the asset management industry operating in the UK. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of £3.5 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In relation to the market facing issues, our member firms are a significant part of the buy-side voice in the capital markets.

We are grateful for the time taken by members of the Bill team to attend our members meeting and for our participation in an HMT stakeholder event.

Our responses to the specific questions are attached. There are many important details and much we support. Two overarching issues deserve mention here:

First, Government's continued rejection of a need to have regard to competitiveness. Our members compete in a global market and their local market is the EU. Gold-plating, inconsistent approaches in supervision and front-running EU and international initiatives are competitiveness issues. The FCA must be expected to have regard at least to the Single Market, recognising it will principally be a supervisor.

Secondly, the need to provide much greater legislative certainty on issues of fairness and predictability:

- Regarding costs – including fairness:
  - in relation to the liabilities, unfair taxation bases and moral hazards arising from the design and operation of the compensation scheme arrangements – this is addressed under Q.29;



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- as between all firms for the costs of the ESAs – this is addressed under Q.32; and
- as to the cost of reporting data when compared with the use made of it by the FCA (an NAO project) – this is addressed under Q.12.

- Regarding certainty of expectations – including:
  - as to what is and is not guidance – especially in light of FSA's apparent disregard of s.157 and 158 FSMA for thematic and general recommendations until recently when we presume a need has arisen to identify what will be transitioned into the new regulator as a rule or guidance. Firms have not previously had this certainty about the standing of such reports and speeches;
  - as to consistency in supervisory approaches and financial promotion decisions; and,
  - revising the RAO and Permissions regime to ensure one to one conformity with EU legislation – this is addressed under Q.19.

- Regarding process and representation – including fairness:
  - in relation to discipline and intervention having regard to the lessons from the Enforcement Review and public law requirements – this is addressed under Q.14;
  - by ensuring the Practitioner Panel has a role in the PRA – this is addressed under Qs.5-10; and
  - in the operation of the PRA veto to prevent competitive distortion and limits on consumer redress – this is addressed under Q.13.

We would expect to work with you on all these issues and those raised within the attached responses, if requested. If we can be of further assistance, please do not hesitate to contact us.

Yours sincerely

Guy Sears
Director, Wholesale

Investment Management Association
ima

## 2. Bank of England and Financial Policy Committee

Ad-hoc tools created for specific circumstances

1. *What are your views on the likely effectiveness and impact of these instruments as macro-prudential tools? (Box 2.D)*

2. *Are there any other potential macro-prudential tools which you believe the interim FPC and the Government should consider? (Box 2.D)*

(Questions 1 and 2) We have no additional proposals; the need for wide and flexible powers is understandable but more important will be the need to maintain a determination to secure global co-ordination and co-operation if macro-prudential tools are to be of wide benefit.

Interaction with monetary policy

3. *Do you have any general comments on the proposed role, governance and accountability mechanisms of the FPC? (Box 2.F)*

It will be essential for the FPC to draw upon the widest sources of intelligence and analysis of developments in the market. In particular we believe that the buy side has a distinct perspective from that of the sell side, and the FPC will need to seek input from investors as well as from the market itself. There were a number of times in the course of the crisis when the authorities appeared to be hearing different assessments from buy and sell sides respectively.

We recommend that, in appointing members of the Committee, care is taken to ensure a significant representation of members with buy side experience.

Coordination

4. *Do you have any comments on the proposals for the regulation of systemically important infrastructure? (Box 2.G)*

We have no particular comments other than agreeing that EMIR will likely require further changes to FSMA and major changes to RCHs ahead of this in the Bill may prove redundant. Co-ordination with FCA Markets and ESMA will be key to managing risk and maintaining confidence in the markets.

## 3. Prudential Regulation Authority

(Questions 5 – 10) We understand from your papers and discussions with yourselves, that as asset managers, whether investment or fund managers, our members will be principally regulated by the FCA. Therefore we have not made comments upon the specific objectives and powers of the PRA. Many asset managers outside insurance groups will themselves have an insurance subsidiary and these captive vehicles will need PRA regulation. We still hope that such special captive vehicles could be exempt from PRA regulation but if they are not, it will be important to ensure the PRA's involvement and the co-ordination mechanisms are not disproportionate to the risks involved.

We think the Practitioner Panel's involvement in the PRA, not merely for consultation purposes, but to identify business impacts and gaps and inconsistencies, would be beneficial. The Consumer Panel could similarly assist the PRA.

We address supervision issues under section 5.

## 4. Financial Conduct Authority

*Regulatory Principles*

11. *What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the FCA?*

We are pleased to note the Government's comments in 4.9 that the FCA will be "an entirely impartial regulator" and "will pursue its outcomes in a way which recognises not only the limitations of regulation, but also the potentially negative effects of excessive regulation on market efficiency and consumer choice"; we agree that "proportionality will be critical" and "the concept of the responsibility of consumers for their own choices will also be important".

We welcome the proposed strategic objective, which itself contains two ideas, that of protecting and that of enhancing. We note that they are to be seen as a single objective. We support the use of the introductory language "must, so far as is reasonably possible".

As regards the first operational objective, we welcome the recognition that the FCA also has an important role in removing regulatory barriers, especially in relation to wholesale markets. Nevertheless even in that regard, we welcome the association of the term consumer with all types of retail customers, financial professionals, financial firms and large corporations.

As regards the second operational objective, we agree there should be a proportionate response between the levels of protection afforded different types of consumer.

We agree with the third objective including the need to counter financial crime (as particularised in Box 4.C). It will be important that FCA is clear as to how its requirements interact with guidance produced by the Joint Money Laundering Group.

We also consider that the FCA should have a prudentially-focussed operational objective. We acknowledge the points made in Box 4.e that commonly FCA's focus will be more on preventing consumer detriment than on avoiding failure. However comments in that Box also state:

*"The FCA will, however, pursue more proactive and intensive prudential supervision for a very small population of 'prudentially significant' firms, where the FCA considers that the firm's failure could individually undermine any of the FCA's objectives."*

Whilst at a fundamental level, objectives are written to provide legal cover for the regulator, they also provide an operational focus. It follows that we consider an additional operational objective should be: "promoting the safety and soundness of FCA authorised persons".

Narrowly, the proposed statement of strategic and operational objectives does not require the FCA to balance the operational objectives between themselves. Published strategic

plans of the FCA, not merely at commencement, must demonstrate to what extent different operational objectives are to be advanced.

We support the proposal that the FCA is to exercise its general functions in a manner intended to promote competition and are pleased that this has been elevated above a "have regard" approach taken in the existing legislation. We acknowledge that the competition mandate needs to be balanced carefully alongside the primary objective of the FCA. We think, however, the fostering of competition will rarely be incompatible with the FCA's strategic objective or any of its operational objectives.

We note the proposal that the FCA must have regard to six regulatory principles. We agree that public understanding should be a matter for the Consumer Financial Education Body.

We agree that issues of financial inclusion are better expressed as Government policy on social issues.

We note your rejection of an explicit factor to contribute to competitiveness of the UK economy, which we had wanted; but we note that you see the FCA playing a vital role in promoting clean, fair and efficient markets that make "London" (and by association the UK) a world leading location for financial services activity. Nevertheless we think competitiveness is an important factor to which the FCA should have regard; although perhaps the definition is too narrow to be confined to the single market as many firms within FCA invest globally - the government has a global competitiveness agenda and therefore so should FCA.

The gold-plating by the FSA over directives, particularly as regards transaction reporting which has cost firms considerable amounts of money, is a matter of competitiveness. So is the insistence of the FSA to front-run EU initiatives or inconsistencies of approaches compared with other EEA supervisors. Such competitiveness issues, relating to the fact of firms operating in the single market, should be addressed in the new legislation.

As regards the decision not to have reference to an innovation factor, in our previous response we had wanted the FCA to have regard to innovation of some kind (recognising the misapplication by some of the label to ill-considered products). We consider, however, this could be met by the regulatory objective of facilitating efficiency and choice in the market for financial services, and would welcome confirmation of this.

*Governance & Accountability*

*12. What are your views on the Government's proposed arrangements for governance and accountability of the FCA? (Box 4.D)*

We agree that using the existing FSA company as the FCA ought to secure a lower cost transition.

We welcome the ability for the NAO to audit the FCA, for which we had called in the past.

We shall want the NAO to consider the cost of data and reporting and how that is used, for which we have also called in the past.

Investment Management Association

We welcome the continuation of the existing Panels, the statutory recognition of the Smaller Business Practitioner Panel and the creation of a Markets Panel. Wide and balanced representation on each will be critical.

Transparency and fairness of decisions will be important. In this regard we identify in our answers areas in which we consider the legislation should better specify obligations of fairness:

- Regarding costs – including fairness:
  - in relation to the liabilities, unfair taxation bases and moral hazards arising from the design and operation of the compensation scheme arrangements – this is addressed under Q.29;
  - as between all firms for the costs of the ESAs – this is addressed under Q.32; and
  - as to the cost of reporting data when compared with the use made of it by the FCA (an NAO project) – this is addressed above.

- Regarding certainty of expectations – including:
  - as to what is and is not guidance – especially in light of FSA's apparent disregard of s.157 and 158 FSMA for thematic and general recommendations until recently when we presume a need has arisen to identify what will be transitioned into the new regulator as a rule or guidance. Firms have not previously had this certainty about the standing of such reports and speeches;
  - as to consistency in supervisory approaches and financial promotion decisions; and,
  - revising the RAO and Permissions regime to ensure one to one conformity with EU legislation – this is addressed under Q.19.

- Regarding process and representation – including fairness:
  - in relation to discipline and intervention having regard to the lessons from the Enforcement Review and public law requirements – this is addressed under Q.14;
  - by ensuring the Practitioner Panel has a role in the PRA – this is addressed under Qs.5-10; and,
  - in the operation of the PRA veto to prevent competitive distortion and limits on consumer redress – this is addressed under Q.13.

We welcome your imposing a duty on the FCA to report on itself when there is a regulatory failure, much will depend on how that term is defined; and we welcome the retention of the section 14, FSMA power as a backstop power to require investigations into the FCA's conduct.

We would trust that a Complaints Commissioner will be part of the accountability mechanism of FCA.

New product intervention powers

*13. What are your views on the proposed new FCA product intervention power? (Box 4.F)*

In principle, we think it is right that the FCA should have a power to intervene in relation to products. What the words "intervene" and "products" mean is the real issue.

We agree that detriment can arise from misconduct in a single firm or from issues affecting a sector or type of product. We are concerned with the suggestion at 4.54 that significant detriment is "more often likely to arise" from such wider issues. On the one hand, it is legitimate for the Government to propose that the FCA has product intervention powers based upon recent experience. However, the defaults of intermediaries which have led to levies of over £420 million being imposed in the last two financial years by the FSCS are better described as failures in single firms than as issues across a whole subsector or type of product. Moreover, the products involved in those cases have not been UK-based, so a new product intervention power might not be able to be used – it was UK or cross border distribution that was at fault. Accordingly, we think it is not controversial amongst lawyers that uses of the existing OIVOP powers could have prevented these sales. This is not an issue principally about failure of design of powers, but of execution.

We would caution against all the FCA's eggs being placed in one basket. Regulatory approaches by the FSA have all too often been characterised by slogans such as "principles based regulation" and "treating customers fairly". Each slogan had merit in its own right but they too often came to dominate, and constrain, supervisory approaches. It is important that FCA does not become slogan-led or subject to fashion but retains both the flexibility to address unforeseen (or previously overlooked) issues and the willingness to use its full range of powers.

Clear ownership by individuals in senior management of key initiatives, such as the RDR, would assist with accountability and quality of output.

We consider that the current manner in which the FSA determines whether any firm poses a significant risk to its objectives has not been a success, measured by the number of complaints have had to be upheld by the Financial Ombudsman Service ("FOS") and by the level of compensation that has had to be paid by the FSCS. The processes for determining the types of engagement with different firms and the MI captured needs to be redeveloped.

It may not be profitable to rehearse the number and width of powers available to the FSA which could have been used to address previous failures. There have long been powers, since the Financial Services Act 1986, to restrain activities which are in breach of the rules, including poor sales processes and the issuance of misleading financial promotions. As the paper recognises at 4.60, the FCA will be able to take action using existing regulatory powers, to make rules to place requirements on products or product features; mandate minimum product standards; or restrict the sale of a product to a certain class of consumers.

The new proposal is to legislate to enable the FCA to make temporary product intervention rules for a period of up to 12 months where it considers it expedient to meet its operational objectives. We note the reference in this regard to the making of rules. We presume this identifies that although a particular product being prepared or manufactured by an individual firm has attracted the FCA's attention, the intervention power will operate against any

product of that type without discriminating between individual firms. The most closely analogous powers presently available against individual firms are the OIVOP power and the power under s.380(1)(a) FSMA to obtain an injunction where the court is satisfied "that there is a reasonable likelihood that any person will contravene a relevant requirement".

Given our assumption that the product intervention rules will operate against a class of firms, then no longer will the regulator (FSA/FCA) need to show that an individual firm has or may breach a requirement in a manner that would presently be actionable. Whilst we support the proposal to have principles published, we consider that the principles under which this power should be exercised should be described in legislation and not left wholly to the FCA. We suggest that one way of looking at this power is to see it as reflecting a change of balance between the pursuit of individual rights and the protection of the wider society. Whilst this is fairly usual territory for regulatory rules, given the impact of these particular rules and the lack of any remedy for firms unfairly denied a business opportunity then, at the very least, the legislation should make provision for the matters identified in 4.64 to be addressed in the principles (these are greater clarity and certainty to industry about expectations in relation to product design and product governance, and codifying the need for proportionate application of such power to reflect that it is unlikely to be appropriate in relation to professional or wholesale customers).

It must appear likely in framing the new product intervention power as a rule-making power that the PRA might have a veto in relation to only some of the firms that might be covered. This could be unfairly distorting.

We recognise there will be a need for coordination with the PRA and refer to this in chapter 5. As we explain there, we are concerned to ensure that the PRA's views about balance sheet impacts will not be allowed to stifle appropriate action to protect consumers.

We welcome the fact that the preventive approach will not be focused purely on retail products and services but will consider the full value chain. We shall continue to raise with the FCA, as we have unsuccessfully with the FSA, our concern that the regulator has not seen the "battle of the forms" regarding the terms of business between the buy-side and sell-side as a market failure some 18 years on from when it was first identified in documents[1] by the Financial Markets Law Panel (as it then was).

Finally, it will not have passed Government's notice that product intervention may be incorporated in MiFID II and will be debated at the time that any UK Bill is being considered. Given Government's proposals and the Commission's statements to date, we would be surprised if the UK had to do more to meet any new EU approach; and if need be s.2 of the European Communities Act 1972 can be used to implement them.

Early publication of enforcement action

14. *The Government would welcome specific comments on:*

- *the proposed approach to the FCA using transparency and disclosure as a regulatory tool;*
- *the proposed new power in relation to financial promotions; and*
- *the proposed new power in relation to warning notices. (Box 4.G)*

[1] http://www.fmlc.org/papers/FLPAgencyFundMan.pdf and http://www.fmlc.org/papers/flp_050926b.pdf

We recognise that a context of the Government's review of the regulatory regime includes:

- There have been over 900,000 complaints to FOS.
- In the financial year 2009/2010 four of the UK's largest financial services groups accounted for 84,718 cases at the FOS (52% of all the complaints received).
- Over £420 million has had to be raised by the FSCS for intermediary defaults in the last two financial years.

We do not therefore oppose these proposed new approaches and powers.

However, their existence places an even greater burden on the FCA to ensure that its internal processes are of the highest standards. In this regard we remind Government of the criticisms made by the Financial Services and Markets Tribunal (as it was) in the Legal and General case and which led to the enforcement process review[2] by the FSA.

The speed at which the FCA may be expected to act in relation to some of these new powers demands a much more explicit statement of the processes and protections be put in place (or preserved in the transition from the FSA). As the Tribunal stated (our underlining):

*"We have had much more time than the RDC to consider all the issues and have had the benefit of much more evidence than they had available to them. In our view the RDC was in error in its approach to the mis-selling case and reached conclusions not justified by the material before it."*

And as the subsequent FSA review stated:

*"It is clearly important that the FSA should listen carefully, and react, to informed and considered criticism; and that those subject to FSA enforcement, and their advisers, should consider that the process has been fair, irrespective of whether they like a particular decision. This report demonstrates the FSA's determination to respond carefully and fully to well-founded criticisms.*

*In approaching this Review, we wanted to re-establish confidence in the fairness of the FSA's enforcement process. We are proposing a number of changes designed to make the process more rigorous, and to establish much more clearly the division of responsibility and separation of operations between those in the FSA who prepare an enforcement case and those in the FSA who make the decision on that case. Essentially, this means the separation between supervision and enforcement on the one hand and the Regulatory Decisions Committee on the other. But we also wished to maintain an administrative decision-making process which involves neither excessive cost, nor too much time. It is important for all affected by enforcement that the costs should be kept as low as possible, and that decisions should not be unnecessarily delayed."*

This seems to us the manner in which the FCA should proceed. But we note that the FSA was not required by the legislative framework to have this approach and moved to it only in the light of "well-founded criticisms". For that reason, we would expect the legislation to expect proper separation of aspects of the investigation and decision-making processes within the FCA. It is entirely possible for legislation to provide sufficient detailed protections.

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[2] http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf

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As regards the specific powers:

*Transparency* – At 4.75, Government states that the FCA should make greater use of existing powers to make disclosure itself, *or require disclosures by firms* (our emphasis). The ability to make a rule requiring disclosure by a firm cannot be used to require publication of information which the FSA (now) and the FCA (in future) could not have published for reasons of professional secrecy (as European law would describe it). A rule requiring disclosure can relate only to the medium of publication (by the firm rather than the FCA), so we welcome the recognition given to this constraint at 4.75.

*Financial promotions* - The implementation of MiFID and the conditional and qualitative approach to disclosures (as in, "if a firm states, then" or "fair, clear and not misleading") should have proved beneficial in that firms could distinguish themselves rather than becoming hidebound by meaningless but prescribed prosaic. So, publication of what has been withdrawn could be useful to assist others in better understanding the boundaries. But we fear publishing what was withdrawn and why will only lead to more risk-averse firms becoming more conservative and less risk-averse firms pleading precedents in aid to be allowed to continue.

It is a matter of record that the FSCS expects to pay some £247.4m based upon claims arising from what the FSCS sees as misleading brochures issued by Keydata Investment Services Limited about an investment plan. In that case, we query how this power would have worked given the brochures were distributed to a number of IFAs. Is it expected that Keydata would have immediately contacted all IFAs and told them to discontinue using it or would each IFA have been told of the decision by the FCA (especially since usage of a brochure by another regulated firm is that firm's own responsibility)? It is critical to ensure these powers will work in practice for issues such as Keydata which is one of the largest non-bank failures (measured by loss compensated) in the FSA period.

*Warning notices* – our comments at the start of this answer about the lessons learned from the Enforcement Review are particularly apposite here. We acknowledge that if the FCA commenced proceedings in the courts then that fact would invariably become public, even before a defence were served, let alone trial. We agree that with the safeguards set out in 4.89, the FCA should have a discretion and not a duty to publish and that the discretion should also provide that notices against individuals might not be published even when a related notice against a firm is published; and that references to individuals could be redacted.

We presume that the references to safeguards relate to the question of publication; there should be no suggestion that any procedural fairness necessary before that step, including Maxwellisation, would be avoided.

We do not consider the publication of a warning notice is a free speech issue as regards the FCA and therefore the FCA should be required to ensure any comments (including in the summary) are limited to a fair and accurate report of the steps taken.

<u>New role and powers in competition</u>

15. *Which, if any, of the additional new powers in relation to general competition law outlined above would be appropriate for the FCA? Are there any other powers the Government should consider? (Box 4.H)*

We consider that both options mentioned could be adopted. In retail consumer matters, the Consumer Panel could have the power to trigger the super-complaint process, whilst allowing the FCA a wider obligation to keep competition under review and be able to make a market investigation reference, as well as respond to a super-complaint from the Consumer Panel.

We welcome the further detail promised by Government.

Wholesale and markets regulation

We agree with the points made in 4.99 to 4.107. We refer again to the lack of apposite and agreed terms in the cash markets (see our response to question 13 above).

Enforcement

It seems sensible to ensure the FSA's criminal powers are moved to the FCA – indeed, as we have previously noted, the Market Abuse Directive permits only a single competent authority in each Member State of the EU. This needs to be the FCA.

European representation

*16. The Government would welcomes specific comments on:*

- *the proposals for RIEs and Part XVIII of FSMA; and*
- *the proposals in relation to listing and primary market regulation.*

We have no adverse comments about the proposed changes to powers; these appear useful clarifications and extensions.

We agree that Government should keep Part XVIII as it is and await any required changes from MiFID II and then use s.2 of the European Communities Act 1972 to implement them (even though this may require a greater alignment of MTFs with RIEs).

## 5. Regulatory Processes and Coordination

Cross membership of boards

*17. What are your views on the mechanisms and processes proposed to support effective coordination between the PRA and the FCA? (Box 5.A)*

We expect that all our members will be regulated directly only by the FCA; though some are in groups which contain PRA firms as well and many will have insurance subsidiaries. In this regard, we support the proposed duty to coordinate as explained in 5.11 of the HMT paper. As regards an MoU, we would stress that it will need statements as to timeliness of responses and decisions.

Managing the risk of disorderly firm failure or threat to financial stability

*18. What are your views on the Government's proposal that the PRA should be able to veto an FCA taking actions that would be likely to lead to the disorderly failure of a firm or wider financial instability? (Box 5.B)*

We remain concerned that the PRA veto must be seen to be an extreme event, particularly if limiting or preventing steps to secure redress for consumers. In particular, it would be helpful to understand whether any of the existing widespread consumer detriment issues seen by FOS might have been subject to a veto. We note the veto should be notified to Parliament unless contrary to the public interest, including financial stability and confidentiality. We are not sure what circumstances would lead to the exercise of the veto that would be compatible with such publication or inclusion in the PRA's annual report.

Accordingly, we consider the chair of the TSC and the chairs of the Panels should be informed in any event of the use of a veto.

<u>Variation and removal of permission</u>

*19. What are your views on the proposed models for the authorisation process – which do you prefer, and why? (Box 5.C)*

We support the alternative approach under which FCA would be responsible for processing the application by an asset manager either itself to be authorised (and even if in a group) or in particular to form a captive insurance vehicle.

In addition to the process issues raised in the paper, we would like to see a revision to the multi-layered expression of permissions through the RAO interacting with the EU directives which regulate most activities (and authorisations) seen amongst our members.

**Permissions: The RAO, FSMA, MiFID and the FSA**

*Issue*
The FSA authorises firms to conduct regulated activities. The RAO sets out the activities which, under FSMA, require regulation. MiFID sets out a range of activities and services which firms must perform in line with the standards set out in that directive. UCITS sets out similar activities and standards for collective investment scheme operators.

Increasingly regulated activities in the UK draw their ultimate origin from European Directives. If the terms used in the UK do not match up with those set out at the European level this can lead to uncertainty and legal expense.

This seems like an ideal opportunity for the three (Directives, RAO and Permissions) to be properly aligned. It would save a considerable amount of time and money at firms, their advisers and regulators if the RAO were to be substantially rewritten to reflect Annex I of MiFID and Annex II of the recast UCITS Directive and to mesh with 2BCD and Solvency II. This would, ideally, provide an inclusive approach to most permitted activities, e.g. a firm with permission to conduct portfolio management would be thereby permitted to conduct all directly related activities (e.g. dealing in investments as agent, making arrangements with a view to transactions in investments etc.) and would not need a raft of extra permissions to be appended to their main permission.

Additionally the current regime encourages the mistaken view that particular permissions represent real business activities. One recent example was bank levies, where the reference to the dealing permission would have captured investment managers placing orders resulting from decisions to invest, which would have made the UK unique in the EEA. The RAO could have been revised at MiFID; we think it now should be.

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*Current Situation*
Currently a small straightforward asset manager may need the following permissions (and despite Schedule 5 of FSMA):

- *Managing investments*
- *Establishing, operating or winding up an unregulated collective investment scheme*
- *Advising on Pension Transfers and Pension Opt Outs*
- *Advising on investments (except on Pension Transfers and Pension Opt Outs)*
- *Agreeing to carry on a regulated activity*
- *Arranging (bringing about) deals in investments*
- *Arranging safeguarding and administration of assets*
- *Dealing in investments as agent*
- *Dealing in investments as principal*
- *Making arrangements with a view to transactions in investments*
- *Safeguarding and administration of assets (without arranging)*

*These are then further complicated, as each permission is granted for a range of investment instruments (see a sample list below), for certain types of customer and is yet further overlain by specific limitations.*

*Investment Instrument*
*Certificates representing certain security*
*Commodity Future*
*Commodity option and option on commodity future*
*Contract for Differences (excluding a spread bet and a rolling spot forex contract)*
*Debenture*
*Funeral plan contract*
*Future (excluding a commodity future and a rolling spot forex contract)*
*Government and public security*
*Life Policy*
*Option (excluding a commodity option and an option on a commodity future)*
*Personal pension scheme*
*Rights to or interests in investments (Contractually Based Investments)*
*Rights to or interests in investments (Security)*
*Rolling spot forex contract*
*Share*
*Spread Bet*
*Stakeholder pension scheme*
*Unit*
*Warrant*

*Customer type*
*Eligible Counterparty*
*Professional*
*Retail (Investment)*

The Permission Statement for a simple firm can fill seven pages.

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*Proposal*
These permissions could be considerably simplified, for instance managing investments could be recast as portfolio management, to bring it in line with the MiFID terms, and deemed to include any activity ancillary to that service, such as:

- Agreeing to carry on a regulated activity
- Arranging (bringing about) deals in investments
- Dealing in investments as agent
- Dealing in investments as principal
- Making arrangements with a view to transactions in investments

Schedule 5 of FSMA provides a model.

The operator of a CIS could be granted one permission to establish, operate or wind up a regulated or unregulated collective investment scheme, in line with UCITS. This could be deemed to include:

- Acting as the depositary or sole director of an open-ended investment company
- Agreeing to carry on a regulated activity
- Arranging (bringing about) deals in investments
- Dealing in investments as agent
- Dealing in investments as principal
- Making arrangements with a view to transactions in investments

We think the RAO should be re-cast and the FSMA permissions and (FSA) Register aligned so that firms and the public can plainly see what a firm is able to do, legal uncertainties are reduced and the regime is understood from the point of view of the businesses that are regulated. Obviously the scope of regulation, the perimeter, will need careful thought but this should not be allowed to continue an opaque regime in which firms have little understanding as to its role and where the need to have so many permissions prevents regulators and policymakers from targeting rules correctly. This becomes especially so where firms are then seen, in recent tax or levy legislation for example, as belonging to some type of business model because they have a dealing permission when that is a UK requirement placed on portfolio managers.

*20. What are your views on the proposals on variation and removal of permissions? (Box 5.C)*

We agree in relation to the FCA powers. As our members are principally regulated by the FCA we have not made comments upon the specific coordination mechanisms beyond noting that as many asset managers outside insurance groups will themselves have an insurance subsidiary, these captive vehicles will need PRA regulation.

We had hoped that such special captive vehicles could have been exempt from PRA regulation but as it appears they will not, it will be important to ensure the co-ordination mechanisms are not disproportionate to the risks involved.

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Approved persons

*21. What are your views on the Government's proposals for the approved persons regime under the new regulatory architecture? (Box 5.D)*

We agree in relation to the FCA powers. As our members will be principally regulated by the FCA we have not made comments upon the specific coordination mechanisms. See our comments above in 20 concerning captive insurance vehicles.

Passporting

*22. What are your views on the Government's proposals on passporting? (Box 5.E)*

We agree in relation to the FCA powers. As our members will be principally regulated by the FCA and unlikely to need passporting for any captive insurance vehicle, we have not made comments upon the specific coordination mechanisms.

Mutual organisations

*23. What are your views on the Government's proposals on the treatment of mutual organisations in the new regulatory architecture? (Box 5.F)*

We have nothing to add.

Rule waivers

*24. What are your views on the process and powers proposed for making and waiving rules? (Box 5.G)*

We are unclear as to why a wider consultation power is being proposed here. It states that where a waiver is granted to a firm entirely regulated by the FCA but which is in a group in which there is a dual-regulated firm, then the PRA must be consulted. We consider this is unnecessarily bureaucratic for rule waivers which could not impact prudential oversight. But we also have a concern as to how rule waivers for complaints handling are used. At times it is perfectly understandable in light of the need to clarify legal issues or co-ordinate wider issue resolution, but there is a concern that it could be used to protect fragile balance sheets so denying prompt redress for consumers.

Supervision of financial groups (and unregulated holding companies)

25. *The Government would welcome specific comments on*

- *proposals to support effective group supervision by the new authorities – including the new power of direction; and*
- *proposals to introduce a new power of direction over unregulated parent entities in certain circumstances? (Box 5.H)*

The consultation states that various EU Directives (including CRD and the Financial Conglomerates Directive), informed in part by the Basel Concordat, require the 'consolidated supervision' of firms carrying out specified activities within a group. Although the text says the consolidated supervisor will predominantly be the PRA, we would expect a large number of asset managers to be lead regulated by FCA despite the presence of a captive insurance

vehicle. As long as the PRA veto over directions is kept at the very high level suggested in 5.70 (reasons of financial stability or disorderly failure) then we think this ought to be workable. It is important that the FSA states clearly and in good time how it envisages the new bodies will deal in practice with such consolidated supervision.
We have no comment about UK unregulated entities.

Change of control and Part VII Transfers

26. *What are your views on proposals for the new authorities' powers and coordination requirements attached to change of control applications and Part VII transfers? (Box 5.I)*

On change of control, we agree the PRA must be consulted and could object if the change relates to a firm entirely regulated by FCA but which is in a group in which there is a dual-regulated firm.

We have no further comments on Part VII transfers.

Insolvency

27. *What are your views on the Government's proposals for the new regulatory authorities' powers and roles in insolvency proceedings? (Box 5.J)*

The PRA's veto should only allow it or the Bank of England to proceed to resolve the firm concerned. The FCA should not be left in a position where a regulated firm is insolvent but action is prevented or delayed.

Actuaries and auditors

Although no question is asked directly, we support the extension of powers to ensure individuals might be disqualified. We are presuming all necessary procedural protections will be provided to any individual facing such a risk.

Fees and Levies

28. *What are your views on the Government's proposals for the new authorities' powers in respect of fees and levies? (Box 5.K)*

As to substance, it will be critical to ensure the costs of the FCA are attributed fairly across all firms. The legislation should address these issues by setting out principles of 'taxation' to which FCA and PRA must have regard. The cost of markets work should also be borne by wholesale firms which are only regulated by PRA. We address the costs of the ESAs under section 7 below.

As to mechanism, we have no comment on FCA operating this process.

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## 6. Compensation, dispute resolution and financial education

Governance

*29. What are your views on the proposed operating model, coordination arrangements and governance for the FSCS? (Box 6.A)*

Whilst we have no objection to there being a single legal entity, FSCS, for contact purposes, we have not yet understood how it is envisaged the various scheme rules will be made and how they will relate.

It is unclear to what extent the PRA will be able to make rules. The paper states it will for "insurance provision". Does this include insurance mediation? And what of mortgage intermediation? Certainly the proposal that the FCA will be able to make rules "relating to all **other** types of financial activity" (our emphasis), makes it no clearer.

Despite the FSA recommencing its funding review, the legislation must:

- Subject to what follows, provide sufficient flexibility to permit any outcomes of that review to be implemented;
- Expect the rules to ensure fairness between levy payers, including as regards their prudential requirements;
- Expect cross-subsidy, if it persists, only to relate to relationships between manufacturers and the sales of their own product lines;
- Expect the rules to seek as far as practicable to provide budgetary predictability
- Provide a role for HMT in approving the rules;
- Start from a basis that is objectively justifiable and not merely an echoing of old SROs and regulatory structures;
- Only depart from EU requirements where there is justification having regard to the accessibility of products on a cross-border basis which may not have to bear compensation costs.

The current regime has not met these requirements.

The lack of predictability of levies was made apparent when FSCS demanded a £233m cross –subsidy on SD01 at the commencement of the calendar year on a month's notice. That constitutes around 4% of gross retail income without the deductions that a tax might allow.

The rules and what constitutes income relevant to the setting of the tariff are not sufficiently clear.

A further indefensible feature of the present Scheme is the trigger for compensation. The Scheme processes claims when **a** liable firm has defaulted not when **every** liable firm has defaulted. In the case of Keydata, the majority of all sales were intermediated by other UK regulated firm which we presume are likely to have owed a duty to consider suitability and may have had co-liability for the Keydata brochures. Whether or not in fact any particular firm did or does is not known or implied by us – and it is not relevant to the point being made. What matters is that there appeared to be no rule requiring examination of any potential liabilities that any other regulated firm in the UK (that is, beyond Keydata) may have to its clients prior to a determination to pay out investors.

The new rules, covering FSCS, should consider the likelihood of another UK regulated firm paying the self-same investor which was its client for conduct of business purposes and expect FCA to take action. Where several firms may have liabilities to an investor for the same event, down a sales or marketing chain, we would have expected that all the firms would have to go through complaints handling and determine what compensation if any should be paid to customers. If that had been a requirement imposed on all firms connected with the sales, it may have secured faster payment to clients and without the intervention of the FSCS.

We do not know what liability any firm may have in the particular case, but we note the *ex gratia* payment announcement of over £50m by Norwich and Peterborough Building Society. Had that been obtained by the FSCS before paying investors and therefore had the regime expected the FSA to seek to recover first from any other regulated firms that might be liable, the FSCS would have needed some £50m less to be levied from the industry for a start. The rules do not envisage a co-ordinated response by the regulatory structure (FSA and FSCS) both to compensate investors but also to ensure the cost of failure is placed at the feet of those primarily liable (even if a residual sum is still needed by FSCS from the industry).

The current approach relieves prospectively co-liable adviser firms from the need to handle complaints or account for their actions to their clients. The FSCS has to step in and pays clients and those adviser firms who may also be liable (and their insurers) only have to await a claim from FSCS. In the meantime those self-same clients may not consider they have been failed by their adviser firm; the payment by the FSCS relates in name to some other person in the chain (here Keydata), and so the clients continue to use that firm rather than going to a new adviser. This is an indefensible structural moral hazard.

Moreover, we now fear a precedent has been set that the default of a promoter (Keydata) in the UK can provoke the payment of compensation to holders of bonds in a Luxembourg entity (Lifemark) which is still operating, and several years before investors would have had any expectation of receiving any return on their investment. We do not understand the policy justification for this state of affairs, especially combined with the effective amnesty from client action provided to any liable intermediary.

The current cross-subsidy arrangements are manifestly unfair in considering every variety of investment business as belonging to a class that can be split between two sub-groups. This is unfair not only to our members (as shown in Keydata etc) but also to many IFAs expected to bear the burden of failures such as Square Mile and Pacific Continental. The sales of offshore structured products, boiler room sales of unlisted shares and the liabilities for misleading brochures need to be much more thoughtfully considered.

The current cross-subsidy arrangements impose an unfair burden upon fund management (SD01) members compared to intermediaries (SD02). The current annual cap on SD01 is £270m and on SD02 is £100m. According to FSA and FSCS, the total eligible income pool for SD01 for 2010/11 was £6,065 million (we have always thought that an overstatement) and for SD02, the investment intermediation sub-class, £3,701 million.

This is equivalent to a maximum 4.45% levy on SD01 and 2.7% on SD02. There is no justification for this. On such figures the cap for SD01 should be at £164m (even on the overstated £6bn figure).

The unfair tax bases are reinforced by the different capital treatments of firms in the different classes. Many firms in SD02 are not subject to any significant capital requirement, which would support the levy basis being lower on SD01 (due to the relative lower risk of uncompensated loss). It is critical that new rules are made which are not influenced by a belief that asset managers are deep pockets which can be expected to bail out poor capitalisation, poor decisions or poor regulation.

Whilst we support the notion of operational independence of the FSCS, its practice of operating to a different levy year than provided in the rules as the basis for contributions between classes can be argued to have led to a reallocation of over £45m of liabilities between classes this year. Practice and rules should be aligned especially as we remain unconvinced that the unfettered discretion given to the FSCS on constructing levies properly reflects the protections expected under Article 1 of the First Protocol to the Convention on Human Rights.

We recognise that a number of the points we have made may not be directly a matter for primary legislation. But it is important that the enabling powers should be such as to allow the replacement of the present Scheme with a fairer model. We are particularly concerned that the split rule-making powers may work against the interests of FCA-regulated firms.

Moreover, the proposals are tantamount to placing very substantial taxation power with the FCA and PRA under open-ended rule-making powers unscrutinised by Parliament or Government. In view of the need to ensure consistency and the competitive implications of this tax-raising power, we consider HMT should have a role in making or approving those rules.
Again this is an area in which there may be changes to the relevant EU directives as the Bill is progressing through Parliament.

Transparency

30. *What are your views on the proposals relating to the FOS, particularly in relation to transparency?*

The proposals on clarity of roles and strengthening co-operation, as well as the feedback loop from FOS are understandable given the number of complaints FOS has to handle.

Accountability of FSCS, FOS and CFEB

31. *What are your views on the proposed arrangements for strengthened accountability for the FSCS, FOS and CFEB? (Box 6.C)*

We support these proposals.

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## 7. European and international issues

Ensuring a consistent and coordinated UK position in international discussions

*32. What are your views on the proposed arrangements for international coordination outlined above? (Box 7.C)*

We think the proposals reflect the thought and engagement since the earlier paper on how to ensure these vital aspects are operated effectively and efficiently. We support these proposals.

However, the proposals do not explore how the costs of the ESAs will be met. Will PRA firms contribute to the costs of involvement with ESMA, or any payment made to ESMA, particularly as regards markets and accounting? How will such costs be apportioned?

We note that the PRA, as regulator of banks and insurers, will hold the UK seat on the European Banking Authority (EBA), it will therefore be at the forefront of regulatory change to the Capital Requirements Directive; however it will not regulate any 'limited licence firms.'

We are therefore mindful to ensure that the interests of this group is appropriately represented in such negotiations and that a proportionate approach continues in the application of this Directive to such firms, which do not trade on their balance sheet and are quite distinct from banks and insurers.

Recent experience of the analogous involvement of CEBS in the preparation of remuneration principles for investment firms was encouraging as it did indeed reflect a proportionate and mindful approach. Nevertheless in this respect, the MoU and lines of communication between the PRA and FCA will be key to ensure the interests of limited licence firms continue to be represented in European fora.

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