Sent by email to financial.reform@hmtreasury.gsi.gov.uk and mail to Financial Regulation Strategy, HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

HM TREASURY: A NEW APPROACH TO FINANCIAL REGULATION – building a stronger system

Dear Sir/Madam,

I am writing on behalf of Deloitte LLP in response to your request for comments on this paper. We welcome the chance to contribute again to the continuing debate on these important questions.

As you will see, we have summarised what we believe are the key issues in an introductory section to our response.

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HM TREASURY: A NEW APPROACH TO FINANCIAL REGULATION – building a stronger system

We welcome the chance to comment again on the Government's proposals to restructure the framework for UK financial regulation, and appreciate the considerable detail provided in this document.

Before turning to the specific questions set out in the paper, we have summarised our principal points in an introductory section.

General comments

Transition

As we said in response to the first consultation, there are considerable risks in the transition process, especially since it is occurring at a time when there is also a pressing need to agree and implement a wide range of changes to regulatory policy, carry out high-quality operational supervision, operate effectively in international fora, and in particular avoid imposing unnecessary costs on business. We know those involved recognise this, in particular the significant personnel and systems issues involved in splitting the FSA[1] into two units and in integrating the arrangements of the PRA[2] with those of the Bank of England: it is also important to consider how best to "grandfather" existing authorisations and permissions.

As such we think it might be helpful to set out in more detail the plans that already exist to mitigate these risks, to satisfy stakeholders that the process is being managed in a way consistent with best practice for a major "change" project.

Timetable

As you are well aware, the legislative timetable is challenging. While understanding the wish to minimise the period of uncertainty, we agree with those who have said that it is even more important to take the time to ensure that the end-product is well-designed and robust. An essential aspect of this, as recognised by HMG, is wide and proactive consultation, which we hope will continue in the months ahead.

Governance

There remain some questions over the proposed governance of the PRA and FCA[3].

The PRA will be a subsidiary of the Bank of England, with a board chaired by the Governor, and will implement the macro-prudential decisions of the FPC[4]. In other respects the paper states the PRA will have operational independence for the day-to-day regulation and supervision of firms, with a majority of non-executives on its board and with the Bank having no formal power of direction over it. However, there is more emphasis in the latest paper on the PRA being part of the "Bank of England group" (eg in discussion of its location, and the "close and constant" working relationship that the two bodies will have). If so this could result in the risk of a bottleneck, given the huge responsibility and workload placed on the individual who is Governor of the Bank and

[1] Financial Services Authority
[2] Prudential Regulation Authority
[3] Financial Conduct Authority
[4] Financial Policy Committee

will also chair the PRA and FPC, unless there are robust arrangements for delegation and other forms of support for these tasks (see Q8).

Within the FCA, the Government proposes a strong specialist markets division to lead on all market conduct regulation: indeed, it sees it as a centre of excellence that will enhance London's reputation globally. We very much welcome this, believing there is a need to distinguish between retail and markets regulation in order to ensure that the regime applied to wholesale business is proportionate and effective by being appropriately differentiated. While the division will need to be integrated into the rest of the FCA, this should not be at the expense of differentiation in some areas: in that context we welcome the proposal to establish a panel for markets practitioners and hope that the distinct identity of the markets area will also be supported by other governance features, such as a strong representation among the non-executive directors of the FCA.

Finally, we think it important that a standing practitioner group is established by the PRA to supplement its other arrangements for consultation with the industry. Ideally this would be supported by requirements in primary legislation, even though substance is more important than form here. Its purpose would not be to act as a lobbying group or as a form of accountability, but instead to be a sounding board that could advise - for instance - on how particular regulatory objectives could be delivered in the most proportionate fashion, and on how well supervisory coordination was working both within the UK and more widely. Having a permanent cross-sectoral body of this type would allow for more effective interaction with the industry, since it could more easily cover the regulatory picture as a whole (and its cumulative impact over time) than might ad hoc arrangements with less knowledge of supervisory objectives and practice.

PRA/FCA coordination

It will be important for the FCA and PRA to work together so that firms do not face unnecessary inconsistencies or duplication in terms of data requirements, meeting requests, supervisory demands and so on. In other words, effective relationship management with the industry will be important to the success of the new structure. The new paper contains more information on how this might work, and we are very pleased that much more detail will be published by the FSA and the Bank of England later in the spring. We believe it would help allay concerns if those concerned also took soundings from the market as to which areas of overlap and duplication might be especially burdensome.

While accepting that the PRA and FCA will not be able to delegate their own responsibilities to each other, there is a particular need to spell out how arrangements on governance and controls, as well as "approved persons", authorisations and permissions, will in practice work, in a way that balances accountability with the need for pragmatism. This might be supplemented by an additional regulatory principle that both bodies should cooperate with one another, to complement the statutory duty to coordinate, unless to do so raises important legal issues.

At a more micro-level there is a need for government to clarify, relatively soon, the boundaries between the PRA and FCA on the supervision of "prudentially significant" investment firms.

Proportionality

This is an important principle, which lies behind concepts such as cost/benefit analysis, considerations of UK competitiveness and the need to ensure that "one size does not fit all". We are very pleased that this now seems to be embedded much more fully in the new arrangements.

Consultation questions

Bank of England and Financial Policy Committee (FPC)

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

Establishing and operating a robust framework for macroprudential supervision is both immensely important and immensely difficult. Since so many of the tools are untested their potential impact is uncertain, and we therefore support the requirement that the FPC set out its proposals for the use of a tool in advance, and review the tool's effectiveness regularly.

In thinking about macroprudential tools we agree work is needed both on the structural and the cyclical issues: the debate on the latter – ie on how to manage the credit cycle – must not lead to neglect of the former. In particular "single points of failure" such as central counterparties must be subject to robust controls and risk management arrangements, and the interconnections within the system should be well understood by policymakers, and by firms themselves. Such steps will address some of the issues on information problems, contagion and market infrastructure set out in paragraph 2.6.

We therefore have some concerns that most of the tools described in paragraphs 2.46 to 2.70 are designed to tackle cyclical excess rather than infrastructural problems, though we accept the latter can sometimes best be resolved at source rather than via a "macro" tool.

Issues around <u>using</u> these tools ("taking away the punchbowl") are well known. But there are also problems about <u>ceasing</u> to use them: for instance market pressures may not allow firms to run down capital in a downturn. If so the problem might be addressed by instead reducing the risk-weightings lying behind the capital requirement, such that headline ratios do not appear to fall. Such an approach would not influence the leverage ratio, however, and would therefore represent only a partial solution.

We agree further work could usefully be done, over time, both on liquidity and on repo margining requirements: both can exhibit "frothiness" over the cycle and in both cases changes in requirements might take effect relatively quickly. In addition both are intimately connected to the traditional central bank role of providing liquidity. However this work needs to take full account of the wider implications of such a step, on the economy and the availability of credit.

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

Achieving financial stability depends on a wide range of factors - a system which protects financial stability in the event of a Long Term Capital situation would exhibit different characteristics from one resilient to a fall in house prices. The FPC needs to have tools for either eventuality.

Direct controls of the sort used in the UK in the early 1980s, and perhaps certain types of limit on loan-to-value ratios, may be circumvented relatively easily (eg by lending unsecured to customers who “happen” to be secured borrowers). As such, it is important to draw both on experience elsewhere and the lessons from history if such measures were to be contemplated here.

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

As we indicated last year, in order to underpin transparency and accountability we would normally prefer a policy-setting body to be given one unambiguous objective, but given the particular nature of financial stability and the difficulty of expressing any target in a way that is transparent and symmetrical this is not easy for the FPC.

We note that the FPC’s objective “does not require or authorise the Committee to exercise its functions in a way that would in its opinion be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term”: this is a step in the direction of proportionality, which we support, but one that may require some reinforcement.

We therefore believe that the specific factors set out in paragraph 2.20 are of great importance: those on transparency are helpfully described further in the paper but there is rather less on the equally important principle of proportionality.

We also note that until there is clarity around the tools to be used by the Committee there will inevitably be some doubts about how far it is equipped to fulfil the role given to it, and the appropriate checks and balances on its activities. But, as indicated earlier, we welcome the requirement for the FPC to set out in advance its proposed use of the tools and to keep their effectiveness under review. Such a principle – a post-implementation review if you will – could usefully be extended to other areas of policymaking, both at national and EU level. In addition it could be extended to consider the interaction between FPC policies and those of a microprudential nature.

Changes in the perimeter of regulation are of great importance. On occasion there may be a need for these to be implemented rapidly, but more often there will be time for consultation with those affected. The general principles in this area in the paper seem sensible (for instance the use of secondary legislation but with the ability in some cases to introduce changes rapidly) but it will be important to scrutinise their use in practice, in particular because if powers are introduced quickly this does not require prior approval by Parliament nor impact analysis or consultation procedures.

More widely, we believe the FPC’s power to make recommendations to the financial sector rather than go via the PRA and FCA (para 2.33) is one that needs further scrutiny, to avoid the risk of ambiguity as to the status of such recommendations, especially given the interplay with the EU regime. It also needs to reflect the principles of proportionality and transparency set out earlier in the paper.

Finally we agree that, as stated in paragraph 2.78, external members should be able to offer insights “from direct experience as financial market practitioners”. The majority of these individuals on the interim FPC do not have such experience: we hope this point can be addressed via successor appointments over time.

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

As indicated in response to Q1 we think this is a crucial area for financial stability. We share the hope that arrangements will be worked out to ensure that the interests of the

Bank of England (as direct regulator of systemically important infrastructure) are effectively represented at the European Securities and Markets Authority by the FCA.

We also note that there is little on the role of the FCA in a crisis in paragraphs 2.137-2.148. Given its role, for instance, on client money issues this seems an oversight.

Prudential Regulation Authority (PRA)

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

We agree it is desirable to set out a set of "principles for good regulation" to which the PRA and FCA should have regard. We very much welcome the principles relating to proportionality (element 2) and transparency (element 6) in the list. Of the others element4 relates to the way firms themselves are run (role of senior management): many other such factors that are equally important are not included. Another (element 1 - the efficiency and economy of the regulator) would in most other public bodies be delivered by other accountability mechanisms. We ourselves would favour the addition of a principle that underpinned the duty of the FCA and PRA to cooperate with one another.

As a society we want a financial system that is not only stable, but also competitive (both internally and externally); efficient; responsive to changes in technology and customer needs; and trusted to deliver appropriate services to customers. While we understand why the PRA should not be described as a champion of innovation and UK competitiveness we still believe that the international character of the UK market needs to be taken into account by policymakers and included in the legislation, separately from the "proportionality" principle, in order to reinforce HMG's wish, in para 3.16 that it wants to see a competitive, world-leading financial services industry in the UK. On innovation we support the idea that "a more nuanced approach" is required but feel that this is not captured by the principles as presently drafted, for instance by reference to the need for an adaptable and responsive financial system.

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?

We note that the range of firms to be covered by the PRA include many of no systemic significance. In particular, we see no reason for including any credit unions within its ambit. To do so will either distract the PRA from its principal tasks, or alternatively lead to such firms being neglected with possible negative effects on customers, relative to the position where they were overseen for prudential purposes by the FCA.

We agree that investment firms that do not deal as principal should not be regulated by the PRA. But within the category of those that do - the "BIPRU 730k" firms - there is considerable uncertainty about how many will be included. This should be addressed as soon as possible along the lines suggested in the paper. Industry is unsettled at not knowing whether only a handful of firms will be covered (as we expect given the description of these as "prudentially significant" in figure 1) or whether the PRA will cover firms of similar size to small credit unions. The position is further confused by the reference in box 4E to the FCA (rather than PRA) carrying out prudential regulation of some complex investment firms including a very small number of "prudentially significant” firms. We assume that the latter group is significant for the FCA, rather than for the system as a whole.

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)?

We support risk-based approaches to supervision which inevitably require judgement. In particular we welcome the return to the practice whereby the prudential regulator should make the purpose of a rule clear. This should also extend to EU legislation, since most prudential policy is set first at the global level (eg Basel) and then via European Directives or Regulations.

Whilst the UK is influential in both fora, if others take a different view it cannot by itself prevent a rules-based approach, particularly in the light of the push towards a single EU rule-book. Unfortunately, detailed rules typically offer less scope for judgment on policy matters. And while regulatory policy is not the same as operational supervision, it can constrain the ability to deliver a judgment-focused approach. In addition, the role of the European Supervisory Authorities, both in safeguarding the application of EU law and in mediating between national supervisors, may further constrain the use of judgment.

In our view a key component of judgment is relative risk, and we hope as a result that the new regime will be risk-based. But such a set-up brings with it some risk of inconsistency or uncertainty in application, and as a result charges of unfair treatment and/or threats of legal action to clarify the position. It is therefore sensible for policymakers to take the time now to look closely at the risks in attempting to move the balance of power in the way suggested.

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

The PRA will be a subsidiary of the Bank of England, with a board chaired by the Governor, and will implement the macro-prudential decisions of the FPC. In other respects the paper states the PRA will be fully operationally independent, with a majority of non-executives on its board (albeit appointed by the Bank) and with the Bank having no formal power of direction over it.

We are conscious that the new structure places a huge responsibility and workload on the individual who is Governor of the Bank and will also chair the PRA and FPC. This will only be manageable if this individual is able to delegate much of the day-to-day work (though not of course the responsibility) to the executive members of the PRA, and receive strong support from other PRA Board members. It would be helpful if these arrangements can be fleshed out in more detail relatively soon, to see if any pressure points in the new structure can be identified and remedied.

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

We agree it is helpful for the PRA to have its own accountability mechanisms to Parliament, independent from those for the Bank of England, and for it to issue an annual report and consultation, as set out in paragraphs 3.72-73.

We also note the powers available to HMT to require a report from the PRA in the light of a significant regulatory failure and/or commission an independent inquiry of the sort held in 1991 and 1995 (but not since then so far as prudential regulation is concerned).

Paragraph 3.7 states the PRA "will not be judged to have failed if a firm that it regulates fails". This raises the question of what constitutes "regulatory failure". Clarity on this point is important in setting appropriate expectations among parliamentarians and regulators alike, and could be helpfully amplified in advance of any problems.

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

We think it important that a standing group is established by the PRA to supplement its other arrangements for consultation with the industry. Ideally its existence would be reflected in primary legislation, though substance is more important than form here. Its purpose would not be to act as a lobbying group or as a form of accountability, but instead as a sounding board that could advise, for instance, on how particular regulatory objectives could be delivered in the most proportionate fashion, and on how well supervisory coordination was working both within the UK and more widely. These disciplines are of greatest importance at the EU level and it is essential that industry inputs effectively into that process: if there is little discretion at national level over the means of implementation, "proportionality" analysis of costs and benefits is of less use there and should not be required.

The wider consultation process is crucial, not least to inform the FSA in international debates. Done well it can be of mutual benefit: it is unreasonable to expect policymakers to evaluate every possible implication of their proposals without external assistance.

Similarly, it is essential that the PRA has access to expert independent input into its decisions. In order to supplement other sources of expertise we consider the Practitioner Panel - on which Deloitte serves – can continue to play an important part in providing such independent input. This might now be particularly important in some areas (eg insurance) in which the Bank of England has historically had less experience.

Financial Conduct Authority (FCA)

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

We welcome the emphasis placed on the promotion of competition for the FCA, particularly but not exclusively in the wholesale markets, but agree it will be necessary to provide more information about how it will interpret this role, and how this will interact with the competition authorities.

We also welcome the greater clarity around the term "consumer champion" in this paper, with the principles of proportionality and consumer responsibility important in this context, and the support that the paper offers for the markets regulation function.

Our views on the regulatory principles were set out in answer to Q5 – we echo the remark that for the FCA, proportionality will be crucial in setting the "appropriate degree of protection for consumers". Indeed, too risk-averse an approach may prevent consumers from having access to affordable products that are likely to meet their needs.

Our views on the supervision of prudentially significant firms were covered in the answer to Q6 – these ambiguities need to be resolved sooner rather than later.

Finally, the FCA's role and responsibilities in the area of economic crime need to be further clarified, given that this is part of a wider subject for consultation. Since the paper suggests that market abuse and anti money-laundering powers will remain with the FCA, as part of "protecting and enhancing the integrity of the UK financial system", it is unclear what if any impact a new economic crime agency would have.

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

As noted earlier, we support the idea there should be a specialist markets division to lead on all market conduct regulation, and ensure the regime applied to wholesale business is appropriately tailored and differentiated from that for retail business.

We note that while there is a need to integrate the division into the rest of the FCA, this should not be at the expense of retaining expertise nor appropriate differentiation in some areas: in that context we very much welcome a Markets committee of practitioners and hope that the distinct identity of the markets area will also be supported by other governance features, such as a strong representation among the non-executive directors of the FCA. We believe underpinning of this type would lessen the risk of retail-style regulation being extended to wholesale markets. This issue has been a continual theme since the establishment of the Securities and Investments Board in 1986 and the carve-out of certain wholesale markets from its remit, which were given to the Bank of England.

Our views on enquiries into regulatory failure are set out in the answer to Q9.

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

We agree that the FSA discussion paper on product intervention is a timely contribution to the public debate on these issues, but think that the outcome of this debate should not be prejudged: the final proposals for the FCA need to take full account of the responses to that paper, and consider whether if these proposals are adopted whether other elements of conduct regulation can be streamlined.

In particular there is a risk that a banning power will lead eventually to the perception that non-banned products have in effect been approved by the FCA, and hence to calls for government compensation if things go wrong. There will also be a need to spell out how such powers interact with EU legislation.

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.*

The issues surrounding disclosure are well summarised in the paper but the key issue is how to balance the general presumption towards disclosure with the specific arguments against it in particular circumstances, on which little is said. We believe this is one area where there may be differences in view between the PRA and FCA, with the possibility that this might on occasion lead the former to veto action on financial stability grounds. Proactive scenario planning for such eventualities would seem sensible.

On warning notices there have been recent cases (both within and outside the regulated sector) where it has emerged that individuals are under investigation and then that no further action is to be taken: it is often said that "discontinuance" as it currently operates does not fully restore the individual's reputation afterwards, despite the presumption of innocence that should normally operate. This power is therefore one that should be used sparingly and with proper care to those to whom it is applied, not least when actions are subsequently halted: it is not clear that the general expectation should be to publish warning notices.

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 have no comments on these proposals until further details are announced.

16 The Government 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 specific comments on these proposals.

Regulatory processes and coordination

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

It will be important for the FCA and PRA to work together so that firms do not face unnecessary clashes in terms of data requirements, meeting requests, supervisory demands and so on. In other words, effective relationship management with the industry will be important to the success of the new structure. The new paper contains more information on how this might work, and we are very pleased that much more detail will appear later in the spring. We believe it would help allay concerns if those concerned also took soundings from the market as to which areas of overlap and duplication might be especially burdensome.

We believe that these arrangements could helpfully be supplemented by an additional regulatory principle that both bodies should cooperate with one another, which we believe would helpfully supplement the other proposals in the paper in this area.

Finally, while accepting that the PRA and FCA cannot delegate their responsibilities to one another, there is a need to spell out how arrangements on governance and controls, as well as "approved persons", authorisations and permissions (dealt with later) will in practice work, in a way that balances accountability with pragmatism.

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 can see the case for such a power but only in extremis.

More generally we hope that the work on recovery and resolution planning would mean that eventually most firms could be closed in an orderly way, in which case this power would be unnecessary.

Until then we doubt whether it is practical to publicise use of the power, since to do might frustrate the purpose of the veto, which is to protect financial stability. This makes its use more problematic, since there could be a loss of transparency as a result.

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

We believe the two proposals are equivalent in effect, since authorisation would be refused if <u>either</u> the PRA or FCA declined approval. If so there are advantages if processing takes part at a single body, most naturally the FCA which in many cases will be the only authority responsible for supervision, but we do not think this is a big issue. We also note that in practice it may be difficult for the threshold conditions to be divided between the PRA and FCA as suggested in para 5.35.

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

See answers above.

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

Since the PRA and FCA will both have powers to ban a person from working in a dual-regulated firm, both should be able to refuse approval initially. That said the more the process can be streamlined along the lines suggested in the paper the better, so long as "leading on" the application is not construed as meaning "having the final say" in cases of disagreement.

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

We have no detailed comments on this proposal, which seem in general terms sensible.

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

We agree it is worth considering the transfer of responsibility for registration of industrial and provident societies to another body, in part to reduce the risk of disproportionate requirements being placed on such firms that do not engage in financial services business.

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

See earlier comments on controls. This is an area where it would be useful to see more detail to ensure that the approach outlined does not become overly bureaucratic in practice, and also that it remains transparent.

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?*

We have no specific comments on these points.

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 have no comments on this proposal.

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

We have no comments on this proposal.

We are however surprised that the paper does not seek comments on paragraphs 5.92-5.97 on actuaries and auditors or mention the interaction with existing professional standards and discipline processes operated by eg the accounting institutes. If change is to be proposed in this area it should be separately flagged for discussion.

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

We see the case for a non-statutory arrangement to collect fees through one body; ie the FCA.

Compensation, dispute resolution and financial education

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

We can see the case for the proposals but hope that these operate effectively, and in a way that does not reduce the effectiveness of the Financial Services Compensation Scheme. It will for instance be important for coordination to be effective on the ground and for Board members of the FSCS to be properly independent.

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

Given the veto/override elsewhere in the proposals to safeguard financial stability, it would be appropriate for any publication of the Ombudsman's determinations to be similarly constrained.

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

We have no comment on these proposals.

European and international issues

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

As noted earlier regulatory policy is increasingly set outside the UK, and so effective arrangements for influencing these fora are crucial. This will depend in part on effective and rapid coordination within the UK official bodies, but much more on proactive involvement on the issues with the European Supervisory Authorities, full engagement with the industry in order to ensure policy is evidence-based, and leadership – as evidenced recently – by senior officials to ensure that the UK continues to be widely respected globally and leads the debate.

On a point of detail we doubt if it will often be necessary for the PRA to rotate its seat to the FCA on the European Systemic Risk Board, given the focus of the latter on the financial stability of the system as a whole.

Impact assessment

We note that option 1 ("twin peaks") is seen as delivering significant benefits via a reduced risk of severe financial crises, presumably through greater focus on macro- and micro- prudential issues. But a separate markets regulator is seen as delivering no benefit at all, and significant cost.

We do not dispute that such an arrangement would be likely to cost more. However, its proponents would argue that this move would produce benefits in terms of a more targeted and appropriate regulation of wholesale markets, with benefits for the economy as a whole. These might be less than the costs of a third regulator – they might not in fact be that large even in gross terms. But it seems most unlikely that the benefits in gross terms would be zero, as stated here.

city limits
the progressive case for financial services reform

Kitty Ussher

Open Left

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CITY LIMITS

Kitty Ussher

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Having said that, all the views, conclusions – and errors – are entirely my own.

Kitty Ussher
March 2011

Introduction

The activities of what we now call the financial services sector have always aroused strong passions. Dante's *Divine Comedy* condemns the 'usurers' to the inner ring of the seventh circle of hell. Three hundred years later, Shakespeare described how Shylock had to forsake his trade as a moneylender, to be redeemed in the climax of *The Merchant of Venice*. The Bible tells the story of Jesus ejecting the moneylenders from the temple; Islam has through the ages prohibited the paying of interest.

Notwithstanding these religious and cultural references, the current standing of the financial services sector in society feels near an all-time low. The public blames the bankers en masse for the financial crisis that began in 2007 and the subsequent recession. This suits the politicians as it shifts the blame away from them and gives an opportunity to load additional taxation on the sector. Indeed, some opinion formers have argued that there is a need to 'rebalance' the UK economy away from financial services.

This pamphlet discusses whether any of these reactions are sensible, or indeed in the national interest. It seeks to improve the clarity of thinking on the debate on the future of the banking sector in Britain, providing evidence to the ongoing Banking Commission chaired by Sir John Vickers. It moves beyond the rich and detailed work being undertaken by regulators at home and abroad to improve the risk management and resilience of individual banks. Instead, it attempts to offer some UK-specific policy lessons to be learned from the crisis as witnessed first hand by the author, who served as City minister from June 2007, when the problems at Northern Rock began to crystallise, to October 2008, just as Lehman Brothers collapsed.

This experience is supplemented by the views of dozens of experts – regulators, practitioners and frontline financial services workers – who were interviewed during the course of the research. Where appropriate, their anonymised voices are heard in the chapters that follow. By proposing specific policy recommendations, the ultimate aim of the pamphlet is to help build a more resilient economic system, which is better able to support people as they live their everyday lives.

The pamphlet is called the 'progressive case' for financial services because it is deliberately pitched to provoke debate among those who would call themselves progressives, of which the author is one. It is right to have a public debate about creating greater stability in the banking sector but it would be wrong for that debate to be informed by gut mistrust or unease about the financial markets and how they work. Many who call themselves progressives would not seek to work in the financial services sector, and as a result there is a gap of trust and expertise between the City and many in Westminster. Yet a strong financial services sector is not only a current reality of modern British life, but also one of the hottest subjects of contemporary public policy discourse as people debate its future. A policy maker who does not seek out information and debate does their citizens no service. Indignation is no substitute for understanding.

These are some questions this pamphlet hopes to provoke:

- Do the benefits of hosting a financial services sector outweigh the potential costs?
- Are we being rational when we talk of 'rebalancing' away from financial services and what does this tell us about how we understand and value certain forms of labour?
- Do the traditional industries have more inherent value than any globally competitive skills-based industry?
- What is really motivating the desire to break up the banks?
- Is a debate about the actual size of pay packets more or less important than the circumstances in which those pay awards were made? To what extent does the pay debate distract us from other things that matter such as the resilience of the banks and the structure of incentives?
- What is the role of government to intervene in this area?

- Why do none of the main political parties feel able to set out their vision for the financial services sector; what are they afraid of?

The hope is that the analysis in these pages will give succour to those who wish to engage in these issues and so lance the persistent boil of hysteria and resentment. The policy recommendations are challenging to government, City and public alike. Some are controversial. None are consensual. So one thing is sure: they will provoke debate.

Outline

The pamphlet starts by recapping the causes of the current recession (chapter 1) and why it had such an impact in the UK. This brief recap is important because it is necessary to understand which policy conclusions flow from the events and which do not. To minimise the risk of such events happening again, we make the following new policy recommendations:

- Open up a policy debate in the UK on how to deal with asset price bubbles at a time of low inflation and interest rates with an independent central bank.
- Use fiscal measures such as stamp duty and capital gains tax on primary residences to curb rapidly rising property prices.
- Government and regulators should pay greater attention to the savings ratio, setting a reference rate that if breached sends a warning to the markets of increasing risk.

Turning to issues around corporate governance, we recommend that the pool of trained people available to undertake board-level appointments across UK plc should be increased. Specifically for the financial services sector, the Bank of England should provide an informal, confidential training and mentoring service for non-executives, focusing particularly on those whose backgrounds are from other sectors, to give them a safe place to ask questions and air concerns (chapter 2).

This pamphlet then looks at the wider contribution that financial services makes to UK plc and whether it would indeed be sensible to 'rebalance' the economy. It shows that in recent years there has been little connection between those countries that have high dependence on financial services and their ability to avoid recession. That does not mean that changes cannot be made. For example, we recommend that the Bank of England should purchase more corporate securities and fewer gilts in any future rounds of quantitative easing.

We highlight the crucial importance of the financial services sector in yielding taxation revenues to the state, which can be spent on the government's priorities, not to mention generating jobs in the centre of London and across the country. There is also strong anecdotal evidence that the existence of a world-class financial services sector in London indirectly benefits other sectors such as manufacturing. In addition, there is strong evidence from the new interviews conducted for this research that the perception of political risk in the sector has risen hugely in recent years, and that this has the potential to reduce the competitive position of London. We conclude that politicians who want to appear tough on the banks would be wise to restrict their comments to strengthening banks as institutions, not weakening bankers as individuals (chapter 3).

Turning to competition issues, including pay and bonuses, chapter 4 shows how the banking crisis was not caused by having banks that were too large and too few, and so it would be illogical to conclude that the banks should be broken up. Instead, it suggests that the real competition issues to be considered are the reluctance of consumers to switch accounts because of the 'hassle factor' involved, and potential failings in the labour market that might be restricting access to the high salaries on offer in the City. On pay it draws a distinction between discretionary bonuses, which should be taxed highly, and contracted payment-by-results arrangements, which can be a useful tool of performance management regardless of the sums involved. Recommendations include extending the remit of the new competition authority so it should also look at labour market failures, and a policy distinction between the taxation of discretionary and contractual bonuses (chapter 4).

Chapter 5 discusses an issue that came up repeatedly during the course of the research, but on which UK politicians are strangely silent: the challenge of responding to the rapid increase in banking and insurance regulation originating in Brussels. This chapter concludes with a recommendation that the UK government needs to put a far greater priority on influencing the direction of EU policy rather than continuing its current reactive approach, and should look again at the way in which the new UK regulatory architecture is designed (chapter 5).

Throughout the analysis, the overarching theme is that much of the reaction and debate that has been seen in the media does not directly flow from the evidence of the real strengths and weaknesses in the financial services sector. A clear-headed look at the facts is required, undistorted by the prism of the public mood, in order to ensure that policy changes actually have the desired effect.

Summary of findings

Bubbles and borrowing

The government should stand ready to use fiscal tools to take the shine off asset price bubbles, in particular by varying stamp duty to a far greater extent and introducing – and varying – capital gains tax on primary residences depending on the direction the housing market is taking.

The government should develop an alarm system for too much personal borrowing by setting a reference rate for the savings ratio. A warning designed to unsettle the markets should be issued if this reference rate is breached in the early stages of a boom.

To support the real economy, in any future rounds of quantitative easing, the Bank of England should purchase more corporate debt and less government debt.

Boards and careers

The financial sector should broaden the experience and skills of executive board members to enhance their ability to question and minimise a tendency towards 'group think'. The government should work with industry to establish a board-level careers service across different sectors where senior individuals, entrepreneurs and leaders from all walks of life can self-refer to receive assessment, experience, advice and training to make them credible candidates for board positions in future.

As part of its new role to monitor systemic risk, the Bank of England should provide an informal and confidential mentoring system for non-executive directors, particularly those from outside the sector, giving them a safe place to test hypotheses and seek analysis and advice.

Careers in the financial sector must attract a broad cross-section of society. The mandate of the proposed new competition authority should be extended to include considering labour market failure, with a primary focus on access to highly paid professions.

The public eye

It is in the national interest to have a strong financial services sector in Britain, as this will increase taxation revenue and have beneficial direct and indirect economic effects. The government needs to be brave and recognise this. It should set out a clear policy direction to support investment in financial services in Britain, designed to capitalise on strengths and address weaknesses.

Policy makers for the banking sector must emphasise maximising benefit for the future rather than seeking revenge for past failures. There is no immediate case for splitting up big UK retail banks, nor evidence to support splitting investment banks from retail banks.

Politicians who want to appear tough on the banks but not weaken the sector should restrict their comments to strengthening banks as institutions, rather than weakening bankers as individuals.

The government should raise a higher level of tax on discretionary bonuses to bankers (as opposed to other forms of performance-related pay) above a certain value when they are not linked to contracted medium-term outcomes.

Europe

The reforms to the UK regulatory architecture should be reviewed through the prism of needing to maximise UK influence, and minimise compliance burdens, within the European regulatory system.

The government should demonstrate a cabinet-level determination to lead the European agenda on financial services. This should include developing stronger career structures for UK graduates, civil servants and business people seeking to gain experience of working in the European Commission.

1 What happened?

When Gordon Brown became prime minister in June 2007, the Treasury that he left behind was on the whole a confident place. The economy appeared in good shape, with unemployment, inflation and interest rates all at historic lows – a validation, it appeared, of the decision a decade previously to make the Bank of England independent.

The Treasury also had a palpable swagger in its relationship with the financial services sector, having belatedly realised and begun to champion its sponsorship role for the City within government, to positive acclaim from the bankers, who had long struggled to find a friendly ear in Whitehall.

The buzz term used to define this new relationship was 'principles-based regulation', a clever phrase chosen to imply not only a light-touch approach that had at its heart an abhorrence of red tape (in contrast with what was perceived by the City to be coming out of Brussels) but also an intellectually superior method of regulation, which eschewed the traditional box-ticking method in favour of broader systems designed to align the incentives of managers with the national interest.

Overall, although often high maintenance, the City was viewed as comprising an important group of stakeholders with whom it was essential to maintain a meaningful two-way dialogue.

Barely a year later, all that had changed. By the end of 2008, the Royal Bank of Scotland (RBS) and Lloyds Banking Group faced no choice but to be partially nationalised in order to obtain the tens of billions of pounds of recapitalisation that they needed to survive. Taxpayers were required to guarantee hundreds of billions of pounds of private bank fundraising, not to mention provide a similar level of insurance to bank assets now perceived as 'toxic'.

Principles-based regulation ended as the Financial Services Authority (FSA) got far more involved in the detail of companies' business plans and ratcheted up firms' capital requirements. And as the recession took hold, public anger turned on the bankers, who the public perceived were to blame, giving political space in Britain for the imposition of one-off levies on firms that paid bonuses, an initiative that set the tone for similar taxes in other countries around the world.

This complete turning of the tables in the relationship between government and the City in such a short space of time could be used to infer that the previous settlement between the two had been sorely lacking. There were certainly faults in the UK system in the run-up to 2007, which this pamphlet discusses. But that is a different thing from saying that the UK regulatory system in some way caused the crisis. With hindsight, greater foresight by the UK authorities could have increased our resilience to the crash when it came, but could not have prevented it.

The analysis in the first two chapters of this pamphlet shows that there were four main causes of the crisis – or four factors without which the crisis would not have happened. These are:

- the lax regulatory regime, which resulted in loans that were too risky to be made, primarily in the US housing market
- the ability of these loans to be securitised, repackaged and sold around the world
- a failure by management in some, but not all, institutions to understand the nature of the risk they were taking on
- in those institutions that did not understand the nature of the risks they faced, a failure by the regulators to correct their mistakes.

The effect of the crisis was then exacerbated in the UK by the low savings ratio that emerged in 2007–08 and a lack of policy tools to deal with the sharp rise in house prices in the run-up to the crash.

The policy conclusions that flow from this analysis are explored in chapter 2. But first, and by way of introduction, we need to recap what actually happened.

Events

Within weeks of Gordon Brown departing from the Treasury the wholesale money markets began to seize up as major financial institutions began to doubt not only the value of their own assets but also those of their trading counterparties.

The cause of the doubt was a change in the perception of the value of previously fashionable products such as mortgage-backed securities and collateralised debt obligations. There was an emerging realisation in mid 2007 that these had been overvalued, and the risk of default of the underlying assets – typically mortgages that had been sold too casually – had been underestimated.

Although such subprime mortgages existed in the UK, they existed to a far greater extent in the USA, where lighter regulation allowed high-risk individuals easily to acquire so-called ninja (no income, no job, no assets) loans, particularly to buy houses. Indeed the US government had actively encouraged greater lending to low-income families for this purpose. Brokers and lenders had responded with alacrity, particularly as they could offload much of their risk by either securitising the loans, or selling them to other global financial institutions to do the same: the so-called 'originate to distribute' model.

This model broke the crucial link that had existed between lenders and borrowers, with the result that originators had little incentive to establish the creditworthiness of borrowers, as they would quickly pass on the credit risk to other institutions. Meanwhile the purchasing institutions did not have sufficient information about the real risk attached to the loans and in any case undervalued that risk in the belief that lower interest rates and rising house prices were simply part of the natural order of things.

When from 2004 interest rates in the USA began to rise, people started to default on their mortgages and because their debt was by this stage spread all around the world the ripple effects also began to spread throughout the global financial system. By mid 2006 some institutions had begun to slow their securitisation activities, concerned at the levels of debt; the exposure of HSBC to the US subprime sector was a big business story in the first months of 2007.

Eventually every financial institution was forced to reconsider the value of any assets their trading counterparties owned which were ultimately linked to mortgages, not to mention their own. By August 2007 the problem was so acute that the risks (and costs) of day-to-day lending rose hugely, fear and uncertainty took hold, and the wholesale money markets suffered what was widely described as a 'heart attack'.

While policy makers had been on red alert for some weeks, causing the Governor of the Bank of England, Mervyn King, to regret his recent decision to deprioritise the Bank's work on financial stability, the first time the British public woke up to the fact that something was up was when at 10pm on a Thursday night in late September 2007 the BBC business editor Robert Peston broke the news that Northern Rock had applied for emergency financial support from a reluctant Bank of England. It did not take long for depositors to start queuing up to take their money out.

The problem with Northern Rock was not that it had been particularly strong in the subprime market, but that instead of relying on its own deposit book to fund its lending it relied on the – normally extremely liquid – wholesale money markets. When those markets dried up, the company soon ran out of cash. It also showed how rapidly a private problem can become a systemic crisis in an era of 24-hour news: it was seeing the rolling news pictures of some people queuing for money that encouraged others to do the same.

To stop the run on Northern Rock, the government was required to underwrite its deposits. The government then attempted to find a buyer at a price that protected the taxpayer interest. When that failed, emergency legislation was enacted to nationalise Northern Rock, some six months after the run. Meanwhile, businesses and consumers alike were beginning to find it hard to obtain credit as banks and other financial institutions became increasingly leery at the prospect of taking on any risk at all, while they scrabbled around with regulators and accountants to try and find a true value for various exotic financial products they found to their dismay that they owned. Many institutions had not fully valued their toxic assets until early 2008. And with mortgages increasingly hard to come by, the housing market began to fall in Britain, thereby reducing even further the value of what were soon to be called 'toxic assets' on the banks' books. Confidence was further eroded by the firesale of Bear Stearns to JP Morgan in March 2008; into this maelstrom RBS managed to achieve the largest ever rights issuance a few weeks later, but it was not enough.

A vicious circle then came into play: consumers worried about the fall in the value of their property began to rein in discretionary spending to pay off their debts, leading to fears of a slowdown, which made the banks even more concerned about extending credit. And with credit constrained firms were forced to shelve expansion plans, making many jobs feel less secure, causing consumers again to pursue a more cautionary approach to spending. There was no help from abroad because consumers in the UK's major trading partners were feeling the same. And so it was that by 2008 the recession became a self-fulfilling prophecy.

In September 2008, just as parts of the market were becoming used to the new world order, the true worth of some of the world's largest institutions began to bottom out. Within a few weeks it became clear that, despite earlier attempts to prop them up, there were still serious problems at the US government's monoline mortgage companies Freddie Mac and Fanny Mae, which were bailed out along with the insurance group AIG. Less fortunate were the folk at Lehmans, which was allowed to go under. Merrill Lynch was only saved by jumping into the arms of Bank of America.

Panic returned, threatening the next tier of vulnerable firms and necessitating in the UK an amendment to the 2002 Enterprise Act to allow the acquisition of HBOS by Lloyds TSB to go through in the interests of financial stability. The emergency legislation that had enabled Northern Rock to be nationalised was then invoked to allow a partial takeover of Bradford and Bingley by Santander and, separately, the government faced the political necessity of guaranteeing deposits in Icesave following the collapse of the Icelandic economy.

In this new jittery world, the FSA, humiliated by its previous championing of principles-based regulation, ramped up its stress-testing of the financial institutions within its purview, concluding that considerable capital raising was required. But with the markets understandably deaf to pleas by distressed banks for more cash, it had to be the government that offered UK firms a life-line in order to prevent further instability in the market that would ultimately impact consumers: on 13 October 2008 it announced that £37 billion would be used to recapitalise RBS and the merged Lloyds TSB/HBOS in return for appropriate ownership stakes.

At the same time the government also made available (for a commercial fee) substantial credit guarantees to underwrite bank lending, which by the end of 2008 had underwritten debt worth around £10billion, peaking at £134 billion around a year later. With the mortgage markets seized up, a similar scheme was then introduced to guarantee trades at the top end of the market in mortgage-backed securities. The USA followed suit, eventually passing its Troubled Asset Relief Programme legislation (TARP) to insure up to $700 billion of troubled assets.

Following a hesitant start in 2007, the Bank of England throughout 2008 and 2009 also made available substantial liquidity to the banking system through its normal operations, the special liquidity system that ran from April 2008 until January 2009 and a permanent discount window facility introduced in October 2008.

By the end of February 2009, the government announced that it had reached agreement in principle with RBS to insure toxic assets worth £325 billion for a fee of £6.5 billion, plus a commitment to lend more into the economy, under a new asset protection scheme (APS) open to all companies. At the same time a further £19 billion was injected into the company.

A week later, Lloyds TSB had also come to the table, with an agreement in principle to insure £260 billion of its assets for a fee of £15.6 billion plus commitments to increase lending to business. But by November, partly as a result of the implicit protection provided by these in-principle agreements, market conditions had improved enough for Lloyds TSB to instead raise on the private markets the capital it needed to compensate for the increased risk it held on these assets.

RBS did proceed with the APS, although with the value of assets protected reduced to £282 billion and a larger 'first loss' to be borne by the company. As a result, by the end of 2009, the government's shareholding in RBS had risen to 75 per cent, with its overall interest – including the protected assets – at 84 per cent.

Back in the real economy, unemployment, which had been bubbling along at a rate of around 5 per cent for the previous few years, had risen to 6 per cent in mid 2008, and up to 8 per cent or nearly 2.5 million a year later. The UK economy began to contract in the second quarter of 2008 and over the six quarters that followed shrank by 6.4 per cent in total, a far sharper contraction than in the recessions of 1990–91 (when the economy shrank by 2.5 per cent) or 1980–81 (when it shrank by 4.6 per cent).

Taken as a whole, these were dramatic times. The popular press was happy to portray the government as spending billions of taxpayers' money to bail out the greedy bankers and the public understandably felt betrayed and outraged at the suggestion that these people took huge rewards for effectively having broken the system. But was bankers' greed really the cause of the crisis and subsequent recession? In reality there were a number of contributory factors, some of which could have been avoided, as the next chapter describes.

2 What could have prevented it?

If the crime that has been committed is causing the worst financial crisis and recession in living memory, then the list of potential culprits is many and varied. Here are a few of them:

- *credit rating agencies*: for providing over-optimistic risk ratings on complex financial products, possibly because their client was the organisation issuing the security in question
- *consumers*: for borrowing what they could not afford
- *statistical economists*: for making over-simplistic assumptions when devising theoretical pricing models for complicated financial products, which had the effect of magic-ing away the underlying risk during the securitisation process
- *traders and/or bankers in general*:
  - for relying on these models without understanding them, and not worrying about their lack of understanding because they seemed to be making money; in the words of the US writer Upton Sinclair, 'It is difficult to get a man to understand something when his salary depends upon him not understanding it'[1]
  - for running excessively high debt–capital ratios, which enabled the crisis to become systemic, rather than isolated to a few institutions
  - for paying out high levels of remuneration rather than using that money to strengthen capital buffers
- *institutional investors*: for failing to change the behaviour of the boards of financial institutions and providing inadequate stewardship of such institutions, instead piling on the pressure for dividends and share buy-banks to boost their returns
- *non executive directors*: for failing to ask the right questions of executive directors

- *regulators*: for allowing the problems described above, indeed in some cases approving risky decisions, and for failing to spot that the institutions they were regulating were taking on more risk than they could cope with
- *the Federal Reserve*: for not realising the implications that would result from the rise of subprime mortgages; in the words of the former Federal Reserve chairman, Alan Greenspan, in a US '60 minutes' TV interview in September 2007, 'I really didn't get it until very late 2005 and 2006'[2]
- *the Clinton and Bush administrations*: for actively encouraging Fannie Mae and Freddie Mac to make subprime mortgages and, some have argued, repealing the 1933 Glass–Steagall Act, which separated retail from investment banking
- *China*: because the rapid growth of the Asian economies led to a savings exodus from East to West that drove down global interest rates and caused a thirst for higher yield products, which caused excessive risk-taking
- *irrational exuberance and/or fate*: because, as Keynes described it, bubbles always happen, from tulip mania to the dot-com boom; this time it was mortgage-backed securities
- *governments*: because they are supposed to be in charge of everything, and were afraid to kill the golden goose of tax revenue

All the above are implicated, although some to a greater extent than others. As discussed in chapter 4, however, the repeal of the Glass–Steagall Act in 1999 does not seem to have had a direct impact on the recent crisis, as most of the firms that faced difficulties were primarily retail or investment banks, not both. The structure of the business was not a predictor of resilience.

All the other suspects bear some responsibility. But to fully understand the implications for UK policy, as this pamphlet seeks to do, we need to start by understanding what happened in the USA, where the problems began.

Primary factor 1: US regulatory environment

It was far too easy to borrow money to buy a property in the USA. A deliberate loosening of the regulatory environment, coupled with low interest rates, and a celebration of the role of subprime markets to enable greater access to homeownership, proved an explosive cocktail, which caused around 20 per cent of all new mortgages to be subprime at the peak of the housing market in 2004–2006.[3]

The main causes were:

- a clear political decision by the Bush and Clinton administrations to ratchet up the affordable housing goals set by the government for Fannie Mae and Freddie Mac; this encouraged the agencies not only to purchase securities backed by subprime loans but to originate such loans as well; an international regulatory expert interviewed for this research stated that this was 'against the explicit views of their internal risk operators'
- the Commodities Futures Modernisation Act 2000, which reduced supervision of financial commodities such as 'interest rates, currency prices and stock indices', enabling the rapid rise of credit default swaps in an unregulated fashion, which later led to the collapse of AIG as well as problems elsewhere
- a relaxation in 2004 by the Securities and Exchange Commission (SEC) of the 'net capital rule' for five investment banks – Bear Stearns, Lehmans, Goldman Sachs, Merrill Lynch and Morgan Stanley. Previously this had limited firms' debt–capital ratios (leverage) to 12:1; once removed, firms were free to invest in a far greater volume of riskier assets, causing debt ratios to rise sharply, in the case of Bear Stearns to 33:1; by October 2008, the chairman of the SEC, Christopher Cox, was forced to concede what many would say was self-evident: 'voluntary regulation does not work'[4]
- a general failure of the regulators to see the rise in systemic risk in the system; instead the lead of Alan Greenspan was followed, who as late as April 2005 gave a speech praising the role of computer-based risk models that used past credit scores rather than predictions of future incomes to decide whether loans should be made:

Where once more-marginal applicants would simply have been denied credit, lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately. These improvements have led to rapid growth in subprime mortgage lending; indeed, today subprime mortgages account for roughly 10 percent of the number of all mortgages outstanding, up from just 1 or 2 percent in the early 1990s.[5]

As profits rose, checks and balances seemed to become even more unfashionable. Online applications for mortgage loans became common, with some companies making a virtue of a product that required no documentation at all. Their online offering included products such as 'no doc' mortgages, which required no supporting documentation, not to mention 'ninja' (no income, no job, no assets) mortgages to people receiving benefits. In May 2006 the subprime lender Amerinquest decided to shut its 229 retail outlets and take all applications online.

Countrywide Financial, the largest US mortgage company, adopted a policy of automated underwriting and others followed suit; by 2007 an estimated 40 per cent of subprime loans had automated underwriting. While they may have been praised by Alan Greenspan, such systems were later criticised for placing disproportionate emphasis on the easily available previous credit ratings, rather than focusing on future income streams. Overall, it appeared that the constraining factor in granting a loan was not the individual's ability to repay, but the company's ability to securitise it.

On top of this, low interest rates allowed companies to offer teaser rates of interest on adjustable mortgages, to make them superficially attractive to investors. In some cases the repayments did not even cover the actual interest accruing, so the overall value of the debt continued to rise over time even when payments were being made.

With more finance available, house prices rose, and so existing homeowners felt flush, raising their mortgages and withdrawing equity to finance consumer spending. So when the US federal funds rate began to rise in 2004, the bubble burst and foreclosure rates rose sharply. The problem was that, in the meantime, the mortgages that should never have been sold in the first place had been securitised and sold around the world.

Of course subprime and excessive lending were not exclusively an American phenomenon. In the UK the growth of the buy-to-let market in 2000–2007 and the easy availability of mortgages offering more than the value of the property were evidence that things were getting out of hand. However, this merely increased our vulnerability to the effects of the crisis, rather than causing the crisis itself: the transmission mechanism that led to the recession in the UK began in the USA rather than the domestic housing market.

In any case, the proportion of toxic assets held by financial institutions that were American in origin vastly outweighed those that originated in the UK, even after accounting for population size. The International Monetary Fund estimates that the value of US-originated toxic assets is around $3.1 trillion, compared with $900 billion in assets originating from Europe and Asia combined.[6]

A UK-based academic who is expert on comparative systems of regulation and brings considerable private sector experience emphasised the difference between bad loans made in the UK compared with those in the USA:

Most UK securitised mortgages are performing as it was expected they would through a cycle this severe, unlike in the US… in the US you can default on your home and they can't take your car. In the UK if you default, you lose everything, so incentives to keep paying are much higher in the UK.

This view was reinforced by a senior investment banker who also has public policy experience: 'US mortgages have an additional "walkaway" risk – you can just leave your house and the bank can't get you, unlike in the UK.'

It follows that had there been greater control over the availability of credit in the USA, particularly that secured against property, the crisis could have been avoided.

Primary factor 2: management failure

Even given the existence of bad debt in the system, it takes a bad manager not to notice it. There is nothing intrinsic about being a financial services company that means it needs to expose itself to excessive risk.

The firms with difficulties were those whose boards did not understand the contents of asset-backed securities and their relationship to the underlying assets, or that creating a synthetic or derivative product does not take away the risk, and that taking risks off balance sheet does not make them go away. Stronger autocratic leadership – as was arguably the case in RBS and HBOS – rather than collective decision making led to weaker institutions.

One industry insider who had worked at RBS described it thus:

Securitisation was popular with the purchasing institution, which felt the risks had been spread to the point of making them negligible. Many of those models had been devised by PhD-level mathematicians but the risk functions within the banks could not understand them and assess them effectively.

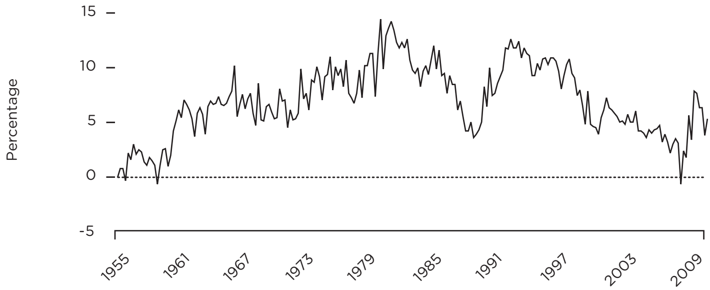
It follows from this that the problems caused by a lax regulatory environment in the USA could have been avoided by better management decisions on the part of some of the world's major financial institutions. We know this is possible because some companies' experience of the financial crisis was more extreme than others. So at the very least it is not the case that the bankers collectively caused the crisis. The better view is that too few bankers did enough to prevent it.

UK aggravating factor 1: private debt

Once the bad loans had been made and some bankers had bought them, problems were inevitable. But the severity of the impact of the crisis in the UK was due to a third factor: the high level of overall debt in the UK economy.

Up until 2007, the British consumer was feeling confident. Low inflation and low interest rates had caused house prices to rise, bestowing a feeling of affluence on much of the economy.

Figure 1 **The UK household savings ratio**



As a result, consumer spending rose, and with it levels of debt. Indeed by 2006 the savings ratio had fallen below 3 per cent, the lowest it had been at any time since the 1950s (figure 1).

Up until 2007 the official government response to this phenomenon was that, as in the 1950s, people were feeling good about life and this was a reflection of the success of economic policy, rather than something to be worried about in itself.

In mid 2008, oil and food prices rose, simultaneously pushing heating, petrol and shopping bills up. This happened at the same time that the banks started reining in credit; for a few months it was virtually impossible to come by a mortgage, at the same time that employees began to feel less secure at work. As we saw in the previous chapter, this led to a collapse in consumer confidence, causing a reining in of discretionary spending and instead a paying down of debt. This eventually contributed to a full-scale economic slowdown, exacerbated by the fact that companies too had been enjoying the easy availability of credit and so were reluctant to borrow further in the face of lower consumer demand to tide themselves over.

Had there been less consumer debt, this effect would have been less pronounced and the recession less severe.

UK aggravating factor 2: regulatory failure by the Financial Services Authority

It wasn't just consumers who lacked a financial safety cushion to shield them against adverse financial effects. Many financial institutions did as well. In order to have a licence to trade from the FSA, banks need to demonstrate they have sufficient capital to withstand unforeseen events. These limits are set by the FSA with a backstop provided by the Basel committee.

The failure of the FSA in the run-up to the crisis was two-fold. First, it exercised insufficient challenge to the institutions that had weak internal risk management: the bad bankers as described above. Second, it failed to ensure that banks had sufficient capital and liquidity to survive a sharp downturn in the housing market, leading to requirements to raise capital in the heat of the crisis.

To be fair to the FSA, these failings were recognised at an early stage. In 2008 it ran a number of stress tests on each of its regulated entities and advised on the level of capital required to be raised accordingly in order to bring stability to the system. At the end of 2007, UK banks had a core tier one capital ratio of 6 per cent; by mid 2009 this had risen to 7.7 per cent.[7]

Being forced to engage in frenzied capital raising in the heat of an economic and financial crisis is not, however, a situation a bank likes to find itself in. Investors are already nervous about the sector, increasing the risks of a failed rights issue, which could precipitate even more instability, not only in the share price of the company concerned, but in the financial system as a whole. And of course the price of the capital rises in troubled times. Moreover, some took the view that having to keep more capital in reserve was the last thing a firm needed when its balance sheet was already under huge pressure; the counter-cyclicality of the FSA's capital raising requirements was not popular.

The alternative of continuing with inadequate capital, however, would have been far worse. The banks that remained needed to demonstrate they had sufficient buffers against the next shock that might occur, in order to restore confidence in the system and make it less likely that that shock would ever happen.

These two aggravating factors – low savings in the UK plus insufficient capital held by UK banks – share many similarities. Even if British consumers had higher savings, and the banks had stronger reserves, the recession probably would not have been avoided but the impact of the recession and the instability in the markets would probably have been less severe.

Initial policy conclusions

It follows from the discussion so far that the regulatory authorities would be wise to:

- raise the capital requirements and liquidity reserves of banks to increase their resilience to a downturn and prevent riskier lending, preferably in a counter-cyclical way so that resilience increases with the risk of a crash increasing
- mandate more effective monitoring of risk within individual firms

So much is already well understood and in the process of being implemented through reforms to the Basel, SEC/Federal Reserve and EU regulatory systems. This pamphlet does not offer a commentary on that process.

We do, however, wish to draw out other UK-specific conclusions that follow from the events that we have seen. Specifically, the experience of the last few years suggests that we need a far clearer debate about the policy tools available to deal with asset price bubbles and high levels of consumer credit in an environment where retail inflation and interest rates are stable and low.

In Britain, before the Bank of England was granted independence, interest rates were seen as a tool for controlling house prices, albeit a blunt one. It is the right thing to have an independent Bank of England targeted on keeping retail inflation (excluding house prices) low, but it prompts the question of asking what policy tools are available when that target is achieved, but house prices are still rising rapidly.

There are two possible answers. The first is regulatory, namely implementing specific loan-to-value ratios for lending into the housing market, which have the capability of being tightened in a counter-cyclical fashion as house prices rise in order to curb the bubble. In Hong Kong, for example, the government has implemented a system of loan-to-value caps in residential mortgage lending in order to curb short-term property speculation and reduce the risk of asset bubbles forming. The caps are linked to property value, so the maximum permitted loan-to-value ratio is lower on high value properties. For example, on residential properties worth over US$1.5 million, the loan-to-value cap is 50 per cent. The new financial stability committee of the Bank of England is therefore right to put loan-to-value ratios firmly in its purview.

The second is fiscal, namely to have the ability to raise property taxes when house prices rise (and potentially lower them when confidence is low). This is a matter for government, not regulators. Successive UK governments have already conceded the principle of using stamp duty as a proactive policy lever. In 1997 a new higher rate of stamp duty of 2 per cent for properties over £500,000 was introduced and then raised to 4 per cent by 2000 as the market boomed. Conversely, the minimum threshold for stamp duty was raised from £125,000 to £175,000 in 2008, in an attempt to restore some confidence to the market during the worst of the credit crunch. Around 2,000 poorer areas in the UK have for some years had a higher threshold, in an attempt to boost activity. And a brief attempt was also made in 2010 to introduce a 'first time buyer' stamp duty exemption.

The UK government should use this tool more aggressively, giving an explicit commitment to use stamp duty as a counter-cyclical tool for dampening a house price boom. Again, Hong Kong provides an example of how such a policy might operate in practice. In November 2010, Hong Kong introduced a special stamp duty of 15 per cent on housing transactions conducted within six months of the owner buying the property, 10 per cent on transactions taking place between 6 and 12 months and 5 per cent on those taking place between one and two years.

Another possibility would be to introduce capital gains tax on primary residences. Like raising stamp duty, this would be simple to implement – it is already done on secondary residences – and there is a strong argument that it is a fair way to raise revenue because it taxes unearned wealth. It is also relatively simple to raise or lower the rate, although it would be important to align any changes with the inheritance tax system to prevent distortions. Having to pay capital gains tax when a house is sold would reduce the so-called wealth effect from rising property prices, whereby consumers run down their cash savings because they (erroneously in this case) believe they are better off, and so can afford to spend more, because the value of their house is rising.

A key advantage of using fiscal rather than regulatory measures to deal with a housing boom is that fiscal measures would boost the national coffers when house prices begin to rise, which would give the government greater resources to spend its way out of any ensuing slowdown in the economy. Unfortunately, it may be harder to achieve political consensus for such changes. In practice both regulatory measures and fiscal measures should be properly debated now, to establish the approach the UK will adopt when the next phase of house price rises begins.

> **Recommendation 1:** The UK government should stand ready to use fiscal tools to take the shine off asset price bubbles, in particular by varying stamp duty to a far greater extent and introducing – and varying – capital gains tax on primary residences depending on the direction the housing market is taking.

In the UK we also need to be more alert to the increased vulnerability of consumers to external shocks if the savings ratio – the proportion of income that is saved rather than spent – is low. Just as the banks should be required to hold more capital to insulate themselves from the effects of a financial crisis or recession, so it should be a matter of policy that a low cash savings ratio should provide an early warning signal to government and regulators that consumers are not adequately protected.

Again, rather than waiting for the next asset bubble to inflate, now is the time for a policy debate on the relevance of the savings ratio as an indicator of excessive consumer vulnerability in the economy. It would be useful to establish a consensus now of the trigger value at which the savings ratio should be viewed as dangerously low, so as to increase pressure on government and regulators to take action when that level is reached. In addition to the fiscal and regulatory measures discussed above to curb over-exuberance in the housing market, it would also be useful to discuss options such as increasing incentives to save via particular products, curbing consumer credit in other areas than housing, or simply issuing a general warning to unsettle markets a little. None of these actions would be attractive to a government faced with a crisis, so it is vital to discuss and agree them in advance.

> **Recommendation 2:** The government should set a reference rate for the savings ratio and issue a warning designed to unsettle the markets if it is breached in the early stages of a boom.

While it is – relatively – simple to constrain excessive leverage in the banking sector, it is harder to prevent the second direct cause of the crisis: management failure in some institutions. The actions of regulators to put an increased focus on risk management, scenario planning and stress testing within financial institutions will help.

But it is also the case that chief executives are accountable to boards and so issues of corporate governance should remain under constant review. In the UK, the Walker review of corporate governance, published in November 2009, made useful recommendations on training and support for non-executive directors, including their expected time commitment, and emphasised the importance of risk management;[8] at the EU level the European Commission has recently concluded its own consultation on measures that can be taken to improve corporate governance in financial institutions.[9]

The challenge is to have serious non-executive financial expertise and experience around the boardroom table of people who have a mindset to challenge constructively the accounting orthodoxies and culture of the firm in question. However, individuals with the necessary experience could well have a conflict of interest (for example, as a result of working for a competitor firm) or be so ingrained in the sector that they may find it hard to deviate from the industry's groupthink. The standard solution is to go for a box-ticking diversity candidate as a non-executive, but if they are perceived as such by other board members then they will have an uphill task in establishing the necessary credibility. This is not a new problem, and it does not exclusively apply to the financial services sector.

During the interviews and consultation for this research, two clear views emerged: first, the most important quality of a non-executive director was the attitude and personality of the individual, who needed to be a team player, yet tenacious in exploring where improvements could be made; second, being a non-executive can be a lonely job, particularly if your instincts take you against the grain of an organisation and you have less information than executive members. Our recommendations are designed to address both these failings.

> **Recommendation 3:** The UK government should work with industry to establish a board-level careers service across different sectors where senior individuals, entrepreneurs and leaders from all walks of life can self-refer to receive assessment, experience, advice and training to make them credible candidates for board positions in future.

> **Recommendation 4:** Within the financial services sector, the Bank of England as part of its new role to monitor systemic risk should provide an informal and confidential mentoring system for non-executive directors, particularly those from outside the sector, giving them a safe place to test hypotheses and seek analysis and advice.

3 An important distraction: the so-called need to rebalance

The argument in the previous chapter is that the main causes of the financial crisis were the lax regulatory environment in the US mortgage markets, which caused a large number of bad loans to be made, the nature of the financial markets which allowed this risk to be spread around the world, and management failure in some global financial institutions.

The UK economy was particularly vulnerable to the loss of consumer confidence that resulted from the banking crisis because of our historic low levels of savings. The situation was not helped by regulatory failings that did not spot the crisis. Some policy conclusions that flow directly from these observations have already been outlined.

Now is the time to address directly the regrettable fact that the public debate on the banks has been following an entirely different chain of logic. We hear repeatedly from politicians on left and right the argument that the recession was caused by us somehow being 'over-dependent' on financial services and therefore peculiarly vulnerable to financial crises, so it is desirable to rebalance the economy so that a smaller proportion of our national wealth is created from the financial services sector – perhaps in favour of manufacturing – to make our economy more robust in the future.

This is a poor argument, for a number of reasons.

For a start, the financial services sector is not the largest sector in the UK economy. At its peak it was around 10 per cent of GDP, less than manufacturing (around 14 per cent). It is therefore illogical to argue that there is an over-dependence on the former that requires a rebalancing in favour of the latter.

Second, those advanced economies that had a proportionally smaller financial services sector did not have a shallower recession, so it does not follow that having a relatively large financial services sector makes a country more vulnerable. Table 1 shows that there is no obvious connection between the size of a country's financial services sector as a percentage of GDP and the contraction of its economy in the recent crisis.[10] Germany and Japan generate proportionally less of their GDP from financial services than the UK but their economies contracted more than the UK economy. The percentage of GDP attributable to the US financial services sector is nearly as high as in the UK, but the US recession was mild in comparison with the UK recession.

Table 1 **Change in real GDP during 2008–09 recession and financial services share of GDP in seven countries**

Country/region	Change in real GDP in 2008–09 recession (%)[11]	Financial services share of GDP (%)[12]
Canada	3.1	Unknown
France	3.2	4.6
Germany	6.3	3.8
Italy	6.5	Unknown
Japan	8.0	6.7
United Kingdom	5.9	8.3
United States	3.5	7.5

Perhaps it would be more useful to consider why problems in the financial services sector can become so damaging to the wider economy. The answer lies in the broad utility nature of financial services – all consumers and firms rely on the services they provide. (A similar argument can be made for the oil and gas industry.) This does not mean we are 'over-dependent' on financial services, rather that the potential risks to the wider public interest from malfunctioning of the financial services sector justifies public action to reduce these risks.

Underlying the argument that we need to rebalance financial services lies a deeper concern that the financial service sector somehow has served to crowd out more sustainable or 'socially useful' activities in the so-called 'real' economy of industry and commerce. The theory goes that capital has been channelled inefficiently over time, away from these sectors towards wholesale markets and property investments, pursuing short-term returns over longer-term value creation.

This is a valid concern, which deserves serious exploration by UK policy makers. Our obsession with home ownership and property prices in this country is not necessarily in our long-term interest. Would a curb on the amount that can be lent in this sector lead to a corresponding rise in lending to industry and consequently to more innovation and economic growth? That is not clear – capital may instead seek greater returns abroad. Should government set up a state investment bank to channel greater investment into industry? It could, as long as it is clear that the taxpayer bears the risk that the market will not carry. Better to create the conditions that support value creation, which include an environment where high skill, high value added, intellectual-property-based entrepreneurial activity that is valuable can find a way to grow regardless of the sector it is in, even if it includes the financial services sector.

As a starting point, the Bank of England's policy of quantitative easing should not simply seek to purchase government bonds on the secondary markets but corporate securities as well. When the policy was introduced in 2009, this was explicitly stated as an aim; in practice the number of corporate as opposed to government securities that have been purchased is very low. Purchasing corporate bonds would not help risky intellectual-property-based start-ups, but it would at least have a positive effect in the real economy by lowering the cost of capital for large corporates seeking to invest and expand. And it would send a signal that growth was something the Bank thought was a relevant consideration, particularly as the new Basel rules make it harder for banks to meet their capital requirements by holding such debt. The problem is that if the Treasury directed the Bank to purchase corporate bonds there might be issues with state aid; the Bank needs to decide to do it for itself.

> **Recommendation 5:** In future rounds of quantitative easing, the Bank should purchase more corporate securities and correspondingly fewer gilts.

Of course it is possible to rebalance away from financial services to manufacturing without in any way constraining the ability of financial services to grow beyond its normal sustainable rate; manufacturing would simply have to grow faster. However, to pursue rebalancing in any other way would not be in our national interest, not just for the reasons explained above, but also simply because it is a lucrative source of economic activity where Britain retains a comparative advantage. A strong case for the City needs to be made, and it is to this subject that we now turn.

The progressive case for the City

Data published by TheCityUK shows that the financial services sector employs around a million people in the UK, of whom around a third work in 'City-type' jobs in the square mile and Canary Wharf.[13] In addition there is important indirect employment, for example an increasing demand for professional services from accountants and lawyers, who tend to cluster around professional services. The Wigley report for the Chancellor put the total employment figures even higher. It stated:

> *Financial services employs some 1.3 million people in the UK – 500,000 of them in London… in addition to this direct employment, it has been estimated that the expenditure of London's financial services employees directly supports a further 400,000 to 500,000 jobs in the UK economy.*[14]

The total tax contribution[15] of the financial services sector in the financial year to 31 March 2010 has been estimated at £53.4 billion in a report commissioned by the City of London from PricewaterhouseCoopers.[16] This equates to 11.2 per cent of total government receipts from all taxes. Each person employed in the financial services sector pays an average of £25,000 in tax. For every pound granted in bonuses, 50p goes to the government, and a further 20p in VAT if the remainder is spent. There are several hundred banks in London, only a handful of which are high street names. Yet the rest are paying tax to the UK government. In the words of one foreign-owned investment banker, 'The UK has the fiscal benefit of the foreign banks without knowing how to deal with them.'

The UK runs a surplus in financial services in its balance of trade; the Pink Book, which publishes details on the UK balance of payments, showed a trade surplus that peaked at £46 billion at its peak in 2008, falling back to around £40 billion the subsequent year, although TheCityUK considers that this might actually be an underestimate.[17]

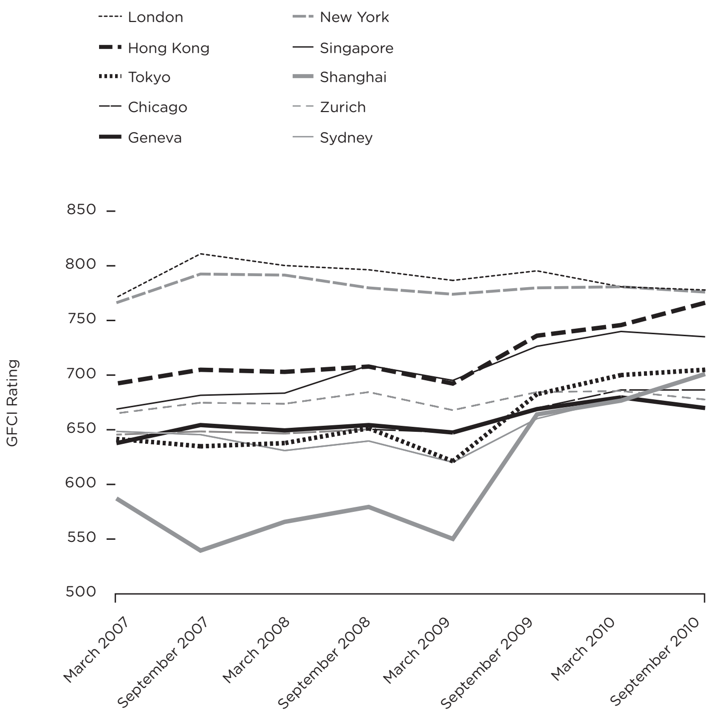
Finally, although necessarily based on subjective measures, London still ranks top of the global competitiveness index for financial services. In an increasingly competitive world, does it make economic sense to try to constrain a sector that is yielding significant revenues, employing large numbers of people, helping to counterbalance the persistent current account deficit in manufacturing and in which we appear to be a global leader?

The evidence points to the opposite: as long as we can ensure that the activity of the financial services sector is regulated in ways that minimise the impact and frequency of economic shocks affecting the wider economy, perhaps it is better to promote it, rather than to try to weaken it.

The sector that cried wolf

The banking sector has always possessed an effective lobbying voice, adept at threatening to withdraw from Britain if it does not get its way in the public policy debate. But with politicians now appearing anxious to align themselves with the public anger

Figure 2 **The Global Financial Centres Index**



against the sector, it is time for a proper analysis of whether it matters if there is a drift away from the UK by high finance.

First, let us look at the extent of the threat. The Global Financial Centres Index (GFCI) has been published twice yearly since March 2007. Over that time it shows London at the top, but most recently the lead over New York has eroded and Hong Kong has now risen to within spitting distance. Indeed, the principal Asian financial centres have all improved their competitiveness substantially in the last few years, with Shanghai being the fastest new entrant, dislodging Frankfurt from the top ten. Figure 2 shows the full picture.

The threat to the UK's position therefore seems real. Two questions follow: why has this happened, and does it matter?

Why are we losing competitiveness?

The GFCI is compiled from two separate sources of data:

- external objective indicators (grouped around people, business environment, infrastructure, market access and general competitiveness)
- interviews with nearly 2,000 financial services professionals

Interviewees rate taxation and regulation as the most important factors in competitiveness.[18] The stagnation of London's GFCI rating in comparison with the marked increase in that of the principal Asian centres suggests that London should pay close attention to the critical areas of taxation and regulation.

The interviews conducted with senior practitioners during the course of the research for this pamphlet support this view. But they have also showed that it is taxation, rather than regulation, that is having the greatest negative effect.

In the words of one global executive, currently based in London:

The 15 per cent income tax rate available in Hong Kong is looking increasingly attractive.

Another said:

Rumours abound of the Swiss authorities ringing people up on the phone and actively offering to negotiate a more advantageous rate of personal taxation.

A third, who had served on the taskforce for the 2009 report on global competitiveness commissioned by Alistair Darling,[19] commented:

The evidence we have is that stability and predictability of taxes are as important as the level.

And a leading policy analyst for a London-based industry trade association reflected what many were telling us when he said:

The 50p tax rate was a policy discontinuity that has raised the political risk for the banks hugely. People are just frightened as to what might come next.

Another, who has 15 years' experience in government as well as in the banking and insurance sectors said:

The decision of the previous government to raise the higher rate tax twice in two years (initially to 45 per cent and then 50 per cent) in contravention of a manifesto promise caused a fundamental breach of trust with many FS executives who are now less inclined to believe political promises on tax within the UK.

A senior practitioner in a major investment bank talks of non-British traders who work across Europe now choosing to move away from London because the environment – the levels of taxation and bankers' position in society – is no longer seen as attractive, with the result that their trades are no longer booked in the UK. Thus the British exchequer loses not only income tax, but also corporation tax from the profit on the deal itself. The *Financial Times* has estimated that Britain will lose £500 million annually as a result of tax-driven migrations of hedge fund managers and employees. The departure of two leading managers (Alan Howard, founder of Brevan Howard, Europe's biggest hedge fund, and Mike Platt, founder of BlueCrest Capital, the third biggest) will cost the Revenue £200 million, according to a *Financial Times* analysis of their funds' accounts.[20]

It is important to recognise, however, that the migration of hedge fund managers and employees has been described by a financial consultant who advises on tax migrations as 'not a flood yet – it's a trickle'.[21] A recent press report also noted that 'the fears of an exodus of bankers have yet to materialise.'[22]

Nonetheless, the lowering of bankers' position in society and increases in personal taxation, as described above, have served to depress morale, and while this may not yet have led to a mass outflow of institutions or professionals, they are likely to have an effect at the margins. At the very least these developments have the potential to dampen the rate at which London will grow in the future, which will reduce future taxation revenues and employment.

In the words of a senior executive in a high street retail bank:

You won't know for definite what the effect is until the damage has been done. The question is, do you want to take that risk? Politicians and political pundits are in denial – they need to decide what they want… and be aware that their decisions are being made in an environment where there is already huge competitive pressure away from London.

Overall there is little doubt that the recent hikes in personal taxation, combined with the rhetoric of banker bashing from government and media, has done some damage to the perception of senior financial services executives that London is a key place to locate. What has emerged from this research is that the perceived lowering of the social status of financial services and the UK's increases to the already relatively high marginal tax rates have had a far greater effect on the minds of senior executives than any talk of higher capital controls or greater levels of financial regulation in general.

Recommendation 6: Politicians who want to appear tough on the banks but not weaken the sector should restrict their comments to strengthening banks as institutions, rather than weakening bankers as individuals.

Does it matter?

If we presume that there has been some attrition at the edges in wholesale financial services, we need to ask whether this matters to the real economy. Putting aside for one moment the loss of tax revenue and some professional job opportunities, would it make a difference outside the square mile and Canary Wharf if we lose our competitiveness?

Of course the reach of the financial services sector goes far wider than London. Witness the alarm and despair felt in Leeds, Bradford and Newcastle when the problems at HBOS, Bradford & Bingley and Northern Rock surfaced. In my former constituency of Burnley, back office functions for several building societies sustain several hundred jobs in one of the lowest wage areas in the country.

But of course these retail jobs would still exist if we didn't have a globally renowned wholesale financial services sector. Yet many of the hundreds and thousands of people employed in this part of banking and insurance still feel a sense of hurt pride when they read the anti-banking headlines, combined with a feeling of injustice when they consider how much their superiors have been paid, certainly if the sessions held with union representatives as part of the research for this pamphlet are anything to go by:

I'm working harder and harder talking to customers all day, getting paid £14,000 per year, when the people who run our company are paying themselves a fortune for messing it all up.

Retail bank worker, South East of England

More interesting is to examine the effect on the wider UK economy if we did not have a global financial centre on our doorstep.

If a medium-sized manufacturing firm outside London was seeking to hedge a contract, or finance a take-over, would this be more expensive if the wholesale markets in London did not exist? The anecdotal evidence that we have indicates that there is an effect. It would still be possible to do the trade – their routine bankers would be able to arrange it for them, but the price could well be higher if there were not highly liquid wholesale markets in the same country speaking the same language in the same time zone.

We heard the following views:

The firm would just get better advice because the City of London is there on the doorstep.

Senior investment banker

In open, efficient, global markets, this should make no difference, however the fact of the matter is that smaller companies will be better covered here, because the banks are here. If the banks were all in France, small French companies would be better covered.

Senior expert in international regulation

If the HQ moved to Asia, the top brains would leave, which would send a powerful signal to the rest of the organisation that the way to attract the attention of the senior managers would be to move too. It'd create a brain drain because the second or third layer of people would want to go too.

Very senior manager, international investment bank

In another interview it was pointed out that having large international banks in the City made it more likely for back office functions to be located elsewhere in the UK. For example, the US investment bank Citi has recently opened a supporting facility in Belfast; JP Morgan has a centre in Bournemouth; and Deutsche Bank has part of its operations in Birmingham.

Overall it would remain useful to be able to quantify this effect and in particular whether there is a link between a lower price of credit available to UK plc and the depth of capital markets in London. The Banking Commission makes a passing reference to the relationship between the structure of the industry and the rest of the economy, but this subject requires further examination. Nevertheless, there is certainly some evidence that over time having a strong banking sector boosts the so-called 'real economy' rather than detracting from it.

Recommendation 7: It is in the national interest to have a strong financial services sector in Britain, as it provides taxation revenue and has direct and indirect economic effects. The government needs to be brave and recognise this. It should set out a clear policy direction to support investment in financial services in Britain, designed to capitalise on strengths and address weaknesses.

4 Market rates, market failure and moral hazard

So far this pamphlet has discussed the causes of the financial crisis, and concluded that regulatory intervention is justified in order to reduce the risk of systemic instability happening again. The particular vulnerabilities of the UK have also been examined, leading to conclusions that greater policy intervention is required to deal with situations when asset prices are high and the savings ratio is low. Arguments that Britain should, as a point of principle, seek to weaken its financial services sector have been dismissed; the sector is an important source of jobs and revenue, and having it on our shores may well also contribute to lower costs of capital for other parts of the economy.

Taking all this together, a general conclusion could be drawn that, provided that appropriate boundaries are set to protect the public interest, the operation of a fairly free market in financial services is a good thing for Britain. This chapter delves more deeply into some of the competition issues that have come to the fore as a result of our experience of recent years. It looks particularly at the issue of pay and bonuses; the fear that there will be no incentive to succeed if banks are seen as too big to fail (so-called 'moral hazard' arguments); and finally discusses some of the issues relating to the structure of the sector as a whole.

Pay and bonuses

If it is wrong to conclude that we are 'over-dependent' on financial services, it is also wrong to conclude from this crisis alone that permanent mechanisms should be put in place to prevent bankers from being paid so much. The greatest sense of public injustice arose from the suggestion that bankers were *paid for failure* in the run-up to the crash; it is important therefore not to conclude that *all* high levels of pay are wrong. Indeed, it can logically be argued that the pay in those institutions that were less risky and able to withstand the economic storm was particularly justified.

Although this point has often been lost in the fracas over bankers' pay, in management theory at least there is nothing wrong with an organisation deciding to pay an individual a particular amount to do a defined job, or having an element of performance-related pay or bonuses when particular targets are achieved, providing they pay income tax like everyone else. In economic terms, problems arise when any of the following happen:

- The individual's incentives are misaligned with the company's objectives, leading to decisions being taken that are not in the company's interests, for example, if the individual is being rewarded for short-term profits and/or share price increases that may not bear any relevance to the company's long-term future.
- The remuneration feels arbitrary and/or its level is determined retrospectively, as can be the case with discretionary bonuses particularly at middle-ranking levels. Again, this can lead to misaligned incentives with disproportionate emphasis on short-term deals and the strength of relationships within the office. The confidential and non-contractual nature of such pay can also lead to discriminatory awards being used to send signals to staff as a proxy for proper management and HR processes. This also acts against the interests of the company because it is rewarding things that are irrelevant to the company's long-term interests.
- Remuneration policies promote an aggressive, macho culture, which reduces checks and balances to excessive risk-taking.

To avoid these dangers, among others, it is right for supervisory authorities to consider pay and bonuses as a legitimate part of their purview. Companies that incentivise short-term gain over long-term success are likely to have cultures that celebrate excessive risk-taking. This is unlikely to be in our overall economic interest.

In this context, it is worth noting that the FSA unveiled its revised remuneration code in December 2010. The code implements guidelines circulated by the Committee of European Banking Supervisors. The effect of the code will be to cap cash bonuses at as little as 20 per cent of the total award, with the rest paid out in deferred share awards, which can be cashed in only after several years. This follows the established private sector practice of having long-term share plans linked to performance. So-called 'guaranteed bonuses' are banned, subject to a few very limited exceptions.[23]

The missing piece in the jigsaw is having this performance-related pay linked and seen to be linked to clear outcomes. As well as ensuring compliance with the requirements of the remuneration code, companies would do well not to shirk from this issue and make sure that they can justify all of their pay awards. The new regulatory code requires banks to develop a comprehensive remuneration framework setting out how pay is aligned with risk. We suggest pay should also be aligned with the achievement of long-term business outcomes. Transparency is key, to ensure that shareholder and management objectives are aligned, and can be seen to be aligned, up and down the organisation. For that reason we support greater disclosure of pay both at and below board level, as indeed the Walker review on corporate governance also suggested. This is opposed by the banks, no doubt partly because they fear the public backlash that could follow from individual disclosures. However, sensible organisations will soon discover that if they publish the achievement of targets alongside pay, it will soon enough ensure that people are not paid for a job they have not done.

The aim should always be to attempt to link the long-term corporate strategy to individual time-limited objectives, which in turn are linked to pay, be it base pay or performance-related. The objectives may not be entirely financial and could, for example, include measures of customer satisfaction or fulfilment of long-term investment plans. Executives should be able to show how remuneration and bonuses are tied to the achievement of long-term objectives, rather than short-term financial results. Shareholders should be invited to scrutinise these longer-term objectives and the debate should be about the strategic positioning of the firm and its business plan rather than quarterly results. This would encourage an even greater focus on medium and long-term value creation on the part of investors and management. And it would end any discrimination in bonus payments at a stroke.

Changes along these lines are in the interests of the owners of the company. They would not require legislation. Rather they should be championed by institutional investors, in so far as they are engaged, and by non-executive directors as a tool to obtain better performance from the board. If executives are told they will achieve a financial reward for the achievement of a predetermined target, then there should be no public anger if they receive that reward after they have achieved the target. The City will react that this would place London at a competitive disadvantage. But since all that is really happening is ensuring that systems are being put in place to align incentives within an organisation, and ensure that nobody is rewarded for failure, it would be a hard case to make.

These are issues for the private sector. But the government can have a role in designing a system that helps change behaviour and align the public interest with the interests of the board. This recommendation is designed to do that.

> **Recommendation 8:** The government should raise a higher level of tax on discretionary bonuses (as opposed to other forms of performance-related pay) above a certain value that are not linked to contracted medium-term outcomes.

The implementation of such a recommendation would require some thought and compliance costs, but these would be more than recouped by the income realised.

Barriers to entry

This recommendation does not fully address the issue of fairness in the economy. There is no denying the fact that for many the high salaries paid in the financial services sector is a source of public discomfort. Remember that the average amount paid in tax annually by someone working in a City-type job (approximately £25,000[24]) is not far off the average gross annual pay for the country as a whole. Ask someone in the City and they will justify this by saying it is the 'market rate' for the job. In a sense this is clearly true, given that an individual can shift between competitor companies to obtain similar if not better rates of pay. But it still begs the question as to why the market rate is so high.

During the course of our research, a large number of different explanations were given for this, such as:

- *The nature of the industry*: because the balance sheets of banks are so large, and the return on equity so great, banks can sustain high salaries even though the proportion of profit that goes on pay is normal.
- *Lack of competition in the sector*: it could be that there are monopoly rents being enjoyed in the banking sector that inflate profits and so permit higher levels of wages to be paid.
- *Compensation*: individuals who are being paid such high salaries are in effect 'owned' by the bank, and the salaries are a compensation for loss of work–life balance. In the words of one insider:

They can tell you how many hours a day to work, when to get on a plane, to move your wedding or honeymoon (I know – I've been there), to be away from home for weeks at a time, to never see your family, to be on call 24/7, and they can fire you just as fast.

- *Personal value*: the level of skills and experience of individuals, including their personal relationships with clients, makes them worth a huge amount to the institution.

However, there is another argument that has not been considered: there is a competition issue in the labour market for professional services, of which City-type jobs are part. Put simply, as the price of something rises when it is in high demand and short supply, why is it that senior bankers are in sufficiently short supply that they command such high salaries? What is it that prevents the price being competed down?

Perhaps, as one of our interviewees said:

It is in the interest of currently employed bankers to limit the number of 'acceptably qualified entrants' so as to maintain salary levels. There is an argument that there is a huge cartel effect going on.

This may or may not be true; the problem is that we have no mechanism for considering it, because our existing competition policy institutions are not able to consider labour market issues, restricting their investigations to the, albeit very important, issues around product markets in the interests of consumers.

Take for example the recent investigation by the Office of Fair Trading (OFT) into the high fees charged for equity underwriting services.[25] The OFT pointed out that the fees for equity underwriting are high and identified a number of ways in which companies could informally improve competitive pressure. But nowhere is there any discussion of whether there are barriers to entry to become an equity underwriter and compete these fees down from a supply angle, because it is not in the OFT's remit to do so.

We therefore recommend that the government uses the opportunity of the proposed merger of the OFT and the Competition Commission to expand the remit of the competition authorities to include labour market failures.

> **Recommendation 9:** The proposed new competition authority should have its mandate extended to consider labour market failure, with a primary focus on access to highly paid professions.

Moral hazard: too big to fail

A basic tenet of economics was ringing loud in the ears of the Governor of the Bank of England, Mervyn King, when he considered to what extent the Bank should provide a line of credit to Northern Rock when it faced difficulties in the wholesale markets over the summer of 2007. His argument was that if banks knew that government support was available, they would take greater risks and it would be more likely that they would have to ask for help. His delay was one of the contributory factors leading to the run on the bank that occurred in September of that year.

The same argument has been running through the discourse in the years that have followed. Are certain banks 'too big to fail' – and if they are, does that not make it inevitable that their management teams will become complacent about risk, knowing that the government will have to step in when times are bad?

A simple analysis of what happens to senior executives when their banks get into serious difficulties should show that, notwithstanding the various bail-outs, there remain serious disincentives to executive complacency. Running a bank that gets into such difficulties that it has to be bailed out by the government is not a good thing to have on your CV. None of the chief executives or board members whose banks were nationalised or part nationalised are currently in post.

An alternative argument can be made that this is irrelevant since they had already made so much money, and built up such a large pension pot, that they didn't need to work. Nevertheless the stigma associated with being seen to have caused a bank to fail remains a significant disincentive. While a bank may survive a government bail-out, that is only because a judgement is made that it is in consumer and/or national interest to do so; there is never any doubt in anyone's mind that a failure of leadership has taken place.

It is unlikely, therefore, that moral hazard exists to a great extent among senior executives. Nobody wants to be in charge of a bank that has to go cap in hand to the government. And investors bear even greater risk. At the moment of rescue, shareholder value tends to be low, if not nonexistent. And in troubled times shareholders rightly take a hit: their holdings are diluted by rights issuances. As a matter of course, all equity in the event of failure – defined as a bank having to enter a so-called special resolution regime – should be wiped out; this didn't universally happen in the heat of the banking crisis, which was a mistake. The position of debt holders should be clarified: their claim should be converted to equity with an appropriately large discount. If this is legally clarified in advance it will of itself reduce the risk of failure; a wider group of stakeholders would have an interest in ensuring that this last resort is not reached and the taxpayers would be protected to a greater degree. The regulatory alternative – of putting the bad debt in a bad bank that is allowed to sink – should be perceived as less attractive to bondholders.

For the same reason it is important that any restitution fund such as the Financial Services Compensation Scheme should not accrue significant capital in advance (and the UK should oppose any such notions coming from Europe). Notwithstanding the undesirable temptation this may create for future politicians to spend the money, it could also lead to a form of moral hazard on the part of financial institutions. If a bank feels that it has already paid upfront into a fund that will help out a fellow bank that is now experiencing difficulties, it will have less incentive to help out at the time of crisis. Far better that firms should feel a common incentive to help, partly to avoid systemic failure, but partly because the failure of one could lead to much higher levies to a resolution fund to be paid by remaining firms further down the line, when the bills of sorting it out come to be paid.

Individual firms' living wills should also set out clear ways in which public and business would be able to continue their routine transactions in the event of a bank being perceived by the regulators as being in serious difficulties; upfront arrangements would of themselves reduce the risk of panic and so the likelihood of a run on the bank, which could make matters worse. Ideally, living wills should aim to keep the bank alive, not simply set out a procedure for the orderly resolution of contracts in the event of failure.

Recommendation 10: In the event of failure, those owning a bank should find their holdings are worthless; debt holders should be converted to equity, any restitution fund should not accrue huge surpluses, and living wills should seek to protect consumer interests not only in the event of failure but at the onset of difficulties.

Break them up?

Another potential solution to the fear that banks have become too big to fail is simply to break them up. However, this argument is based on a number of serious misconceptions.

Splitting retail from retail

There are two arguments advanced for breaking up the retail banks in Britain. The first is that smaller banks are less of a problem to resolve if they go under. This is true. The USA, for example, has a large number of small institutions. Bank failures at this level are common and the consumer compensation scheme is able to cope with them, albeit at high cost to the individuals involved. However, there is a problem with this approach, namely that small institutions are often weaker. They are unable to diversify and lack efficiencies of scale. They may suffer a lack of local competitive pressure, which makes them inefficient and vulnerable to an external shock. Indeed the US Federal Deposit Insurance Corporation has estimated that 300 community banks went to the wall in the recent crisis, with a further 800 on high alert.

The UK experience bears this out: the fall-out from the financial crisis saw the demise of Bradford & Bingley and Dunfermline Building Society and a number of smaller institutions as well as Northern Rock. Breaking up the retail banks would also have the potential downside of lessening competition on the high street from the reintroduction of local monopolies and a loss of efficiencies of scale, leading to higher interest rates and charges, not to mention the disruption to management teams at a time when they are attempting to rebuild balance sheets.

The second argument advanced in this area is that at some point it is important to consider whether there is sufficient competition in the retail banking sector. There is a perception that there is over-concentration in the sector, not helped by the deliberate suspension of competition law in order to facilitate the shot-gun marriage between Lloyds and HBOS at the height of the financial crisis. We certainly need to have a view on this, not least because at some time it will be right for the taxpayer to recoup its investment in Northern Rock, Lloyds Banking Group and RBS, and so we will need to decide the best way to sell these stakes back into the market.

The Independent Banking Commission is looking at these issues, but this argument about competition in the sector may not be as simple as it first appears. First, by some measures the UK market is no more concentrated than that in comparable countries. Research by the International Monetary Fund shows that in the UK five banks own 65 per cent of assets, the same as Germany and Canada, but more than Australia where the equivalent number is three, and France, where it is two. Even in the USA, which is normally touted as the country that has a far less concentrated sector because of its high number of small organisations, a mere six banks own 65 per cent of banking assets.[26]

The Herfindahl index is used as a formal measure of levels of banking concentration; a value below 1,000 is thought to indicate a low concentration, and one above 1,800 a high concentration. Research by the European Central Bank shows that the UK value on the Herfindahl index was 467 in 2009, lower than the EU16 average of 663 (or 632 for the EU27).[27]

Second, the merger between Lloyds TSB and HBOS has already been considered by the competition authorities. Under state aid rules, the European Commission has required Lloyds Banking Group to divest 600 branches, equivalent to 4.6 per cent of the personal current account market.[28] This lessens the urgency of a full scale competition inquiry by the UK authorities, although the issue should be kept under review, not least because the Office of Fair Trading in October 2008 identified that there was a 'realistic prospect' that the merger would result in a 'substantial lessening of competition' in relation to personal current accounts and mortgages, and services for small and medium-sized enterprises in Scotland. Since then, however, the work of the OFT has focused on the reluctance with which consumers switch current accounts, not because of a dearth of suppliers but because of the hassle factor involved.[29]

Recommendation 11: There is no immediate case for splitting up big UK retail banks.

Splitting investment from retail

Much has been made of the argument for splitting investment banks from their retail arms. As mentioned in chapter 2, part of the debate in the USA has focused on the decision in 1999 to allow retail and investment arms to exist in the same banking group, by repealing the Glass–Steagall Act in 1933, which had prevented it (and was in turn a reaction to the 1929 crash).

However, the experience of the recent crash indicates that there is little evidence that banks were either more vulnerable or more likely to make bad risk judgements if they had both retail and investment arms. It is just as possible to take on too much risk when signing a deal with a retail customer (indeed that is how the crisis started) as it is when signing deal with a wholesale customer. Politicians are wrong when they draw a distinction between a 'safe' retail bank and a 'casino' investment bank. In the UK, Northern Rock, Bradford & Bingley and Dunfermline Building Society all had to be rescued; none was involved in investment banking. Similarly Lehman Brothers and Bear Stearns, both of which collapsed, did not have mainstream retail operations. Indeed research published by the European Central Bank is clear that a diversified model of banking is less risky than a specialised one.

In opposition, these facts appeared to be overlooked by the Liberal Democrat party, which made it clear it would favour the introduction of 'a modernised Glass–Steagall' act here.[30] In government, the Banking Commission chaired by Sir John Vickers appears to be considering breaking up investment and retail. I argue that there is no clear logic for this.

Recommendation 12: There is no evidence to support a case that investment banks should be split from retail banks.

Nevertheless there is a serious concern, at least in the eyes of the public, that investment banks should not be able to 'gamble' their retail deposits. We believe this issue is adequately addressed by having higher and countercyclical capital requirements and more effective monitoring of risk rather than by making value judgements on the nature of the companies themselves. Even in the USA, despite initial indications to the contrary by the Obama administration, the efforts of the Frank-Dodd bill to split retail from investment have been watered down to a restriction on large-scale property trading on the part of investment banks.

Despite this analysis there remains a concern that large banks present a greater systemic risk simply because the economic effect of failure is greater than for small banks. For this reason it is important that regulators persist in their efforts to clarify what happens in the event of that failure occurring. All financial institutions should have active so-called 'living wills', which spell out how contracts would be unwound in the event of failure. In the words of one of our interviewees, 'the black box needs to be kept there on the shelf'.

Subsidiarisation

An alternative to break-up could be to require universal banks to subsidiarise their operations within the UK; indeed the Banking Commission may recommend this. Then capital requirements would apply to each subsidiary, thereby avoiding part of the 'Icesave problem', when the UK authorities were unable to require Landesbanki to hold more capital because it only registered a branch, rather than a subsidiary, in the UK. (The other part of the 'Icesave problem' was that the Icelandic government could not afford to pay out to British consumers what they were owed, even though a compensation system was in place.)

However, this is unlikely to find favour with EU law, where the home–host branch system allows cross-border companies to set up branches within the single market (including the European Free Trade Association). If a company was based in another EU country, the British regulator could not therefore require a subsidiary in the UK. It would also arguably reduce resilience in the system as it would ring-fence capital for large international banks, preventing resources from being deployed where they are required, not to mention leading to a complex fragmentation of the regulatory system.

It is to European matters that we now turn in the next chapter.

5 Europe – the elephant in the room

Since coming to power in May 2010, the Coalition Government has been conspicuously busy in the field of domestic financial services policy. The domestic regulatory architecture has been ripped up and refashioned, eliminating the FSA, passing its responsibility for macro-prudential issues to a new prudential regulation authority responsible to the Bank of England, with issues relating to conduct and markets going to a new consumer protection and markets authority. The Banking Commission has been set up to look at many of the issues covered in this pamphlet, although much dust will have settled before it actually concludes.

Those interviewed in the research for this pamphlet have had plenty to say about all of these issues, and their views are reflected in the text. But there is a further theme that has arisen again and again, on which British policy makers from all political parties appear eerily silent: the extent to which Britain's competitive position is threatened by its apparent inability to drive (or even sufficiently influence) the European regulatory agenda on financial services.

Bob Wigley, in his report for the Mayor of London on the City's competitiveness, came to the same conclusion. He wrote, 'London's historically supportive overall context is threatened by the increasing influence of EU regulations' and that 'many of the executives interviewed expressed concern that the EU policymakers… have had little interest in preserving London as a financial centre'.[31]

A senior executive at a global investment bank simply told us that 'Britain's success in financial services depends on what happens in Europe.'

This is not a new issue; the Euroscepticism of many people working in City-type jobs in part derives from their frustration at having to react to, and in many cases attempt to correct the weaknesses of, regulatory innovation from the European Commission in the field of financial services. As one person we spoke to commented, '26 out of the 27 countries represented in the European Parliament can exercise power over financial services without any responsibility.'

The situation has acquired a new urgency by the reaction of European policy makers to the financial crisis – to increase the pace of legislative activity and centralise in Brussels the regulatory architecture.

This change of momentum derives from the high level agreements reached at G20 meetings in London, Toronto and Pittsburgh to reform the way that financial services are regulated; since the sector falls under single market legislation the European Commission has taken it upon itself to initiate the relevant legislation, and is supported by many MEPs in doing so.

In February 2011 there are 16 reports related to financial services reform being considered by the Economic and Monetary Affairs (ECON) Committee in the European Parliament, on various subjects including harmonising deposit guarantee and investor compensation schemes, restricting OTC (over-the-counter) derivatives, and requiring greater transparency for short-selling with the potential to temporarily outlaw it and restrict credit default swaps.

There are many more reports in the pipeline, for example on bank capital adequacy (CRD4), bank resolution, MiFID2, total reform and the regulation of credit rating agencies, harmonisation of insurance guarantee schemes, harmonisation of corporate governance relating to financial services, and the solvency regime for occupational pensions. In insurance, the capital regime for the entire sector is being reworked over seven years through the Solvency II programme, which will start in 2012.

Not all of these reports are driven by a desire to boost the single market; some are the result of a misplaced analysis of the causes of the financial crisis. The threat to the UK arises, as the Wigley report identified, because the proposals are not designed with a detailed understanding of the City of London. Coupled with the fact that the final decisions at council level are made by majority rather than unanimous voting, Britain runs the risk of finding itself subject to decisions that are suboptimal: on at least two recent occasions (over the Alternative Investment Fund Managers Directive (AIFMD) and supervision) Britain has had to back down on its preferred course of action for fear of being outvoted.

There are many examples of Britain fighting excellent rearguard actions to ensure that European legislation in the field of financial services either supports or at the very least does not disadvantage the position of the UK industry. Recent examples include amendments to the AIFMD and work on Solvency II. This is a tribute to the work of senior UK officials in Brussels, British MEPs and the financial services sector working together via teams at the Treasury and FSA.

Unless the British government implements significant structural and attitudinal changes, however, over time European legislation will inevitably chip away at the position of the UK financial services sector. At best, this sector is required to spend burdensome time and effort taking defensive action against European initiatives; at worst, legislation will get through that is not in Britain's interests.

During the course of our research, the situation was summed up by a representative from a global insurance and pension company, who deals with government and regulatory risk: 'The UK's efforts in Brussels are very reactive, we are not shaping anything.'

Matters are not helped by the fact that the reforms to the UK domestic regulatory architecture are distracting officials when they should be focusing on changes to the EU architecture that are taking place at the same time. The FSA is in the process of being disbanded, to be replaced by the new Prudential Regulation Authority (PRA), under the auspices of the Bank of England, with the consumer function hived off to the new Consumer Protection and Markets Authority (CPMA), which will also include parts of the Office of Fair Trading. At the same time an entirely new system of financial regulation has just been set up in Europe, consisting of three main European supervisory authorities: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the

European Insurance and Occupational Pensions Authority (EIOPA).

As the FSA noted in its written evidence to the Treasury Committee inquiry on financial regulation (published October 2010):

With the ever growing importance of the European regulatory regime and framework, it will be essential that the Prudential Regulation Authority and the Consumer Protection and Markets Authority are able to represent the UK's interests effectively internationally. The PRA/CPMA split of responsibilities does not map neatly onto the sectoral split of responsibilities (into banking, insurance and securities markets) of the new European Supervisory Authorities (ESAs), which will come into operation on 1 January 2011, or to the global standard setting committees. The ESAs will determine the detailed regulatory standards that will apply in the UK and have a significant say in how cross-border supervision is conducted.

There is thus a risk that the single UK regulatory voice in some cases is weakened by the fact that two or more organisations will share the representational role in the various international regulatory committees. In other cases (especially in Europe) the UK will only have one vote on each committee and will need to resolve conflicting objectives and interests between the various interested UK authorities. This can be mitigated through clarity in the roles and objectives of, and effective coordination between, the PRA and CPMA. Coordination will also need to extend to The Pensions Regulator and potentially other UK authorities.[32]

An executive of a UK-based wholesale financial services trade body expressed the fear to us that 'we will take our eye off the ball in Europe because we are distracted by the reforms to domestic regulation'.

> **Recommendation 13:** The reforms to the UK regulatory architecture should be reviewed through the prism of needing to maximise UK influence, and minimise compliance burdens, within the European regulatory system.

There are also cultural problems, on both sides. The UK regional chair of a financial services union, who serves on an EU social dialogue committee on regulation, told us she was unable to fight effectively for the interests of UK plc because no one on the British management side bothers to turn up, because they did not believe in the social dialogue model. Conversely, others have said that since the UK is not part of the euro, their voice is weakened.

In the European parliament, the failure of Conservative MEPs to join a mainstream political grouping is seen as a major disadvantage when it comes to the influence they have in crucial committees. An EU financial services policy analyst explained it to us clearly:

The impact of British MEPs is marginalised by the very large number of Conservative and UKIP members elected in 2009, the former having very little influence following their exit from the EPP, the latter never present… Britain has six MEPs on the ECON Committee but two of them are members of the ECR group so they are not taken seriously. Immediately the UK's voice is diminished.

The main political groups in the European Parliament all take a very pro-EU integration, anti-City stance and have an informal arrangement to support each other in efforts to clamp down on the activities of financial institutions… There is very little that UK MEPs can do about this. They are either isolated within their own political groups on some of the most sensitive issues, or in the case of the Conservatives, they are unable to make significant impact on proceedings, despite having a strong, knowledgeable team. They are prevented from obtaining reports and their amendments largely ignored.

However, others told us that informal cooperation was still possible across the divides of European groupings.

Meanwhile, the familiar theme arises that British voices are not being taken seriously because we are not seen as fully signed up to the European project. One of our interviewees who had high-level experience of working in European institutions remarked in relation to financial services investment said: 'There is a really unhealthy attitude among some in the EU that seems to say that "if we can't have it, then London shouldn't either"'. And with less than 2 per cent of European Commission staff being from the UK, and the failure of Britain to construct mainstream career paths for British civil servants in and out of the Commission, the list of people on whom we can call to press British interests is dwindling.

Part of the problem is that within Whitehall the European dimension of policy is often perceived as an add-on to the domestic agenda, rather than as essential to achieving mainstream objectives. Such thinking must be avoided in relation to the regulation of financial services, since it is becoming ever more obvious that the European dimension is crucial. The rapid rotation of junior ministers prohibits the building of long-term relationships between European ministerial counterparts, which can be used to smooth negotiations at the crucial stages. Although senior staff at the UK Permanent Representation to the EU (UKRep) are often Whitehall's best, they often lack ministerial backing on the bread and butter issues in Brussels to do their jobs effectively.

To maintain Britain's pre-eminent position as the global number one in financial services, the UK needs to turn its relationship with Europe on its head. Britain should see our membership of the European Union as an opportunity to enhance our competitive position in financial services, and the EU's structures a mechanism through which this can be achieved. We should invest the time and resources to making legislation work for us, and therefore for Europe as a whole, rather than persisting with a defensive and reactive position.

Such a change will require cabinet-level determination, and a Whitehall machine dedicated to ensuring that the pan-European regulatory platform will allow London to fight off the competitive threat from Hong Kong and Singapore. Under the current division of responsibilities within Whitehall, this machine should be located in the Treasury. However, there may be an argument that sponsorship of the financial services industry should be shifted to the Department for Business, Innovation and Skills in order that the person responsible for championing the sector is the industry secretary. This would make some sense given their general business sponsorship role and as many other issues routinely considered by BIS also have strong European dimensions, but coordination with the Treasury would still be required given that many of the relevant issues eventually come to the Ecofin Council. This issue is discussed in the recent Demos pamphlet *National Treasure*, which concludes that the City minister should span both departments, with the routine industry sponsorship role, plus the appropriate people and resources, shifting from the Treasury to BIS.[33]

It is worth noting in this context that the current government in opposition promised a full-time Treasury minister responsible for, and largely based in, Brussels. This has not materialised, a fact that many interviewees found regrettable.

At present, there is ineffective coordination within the industry, with many trade bodies putting out a lowest common denominator position that is of little use either to European Commission officials or to the companies they purport to represent. The new minister should be responsible for mapping influences across Europe and ensuring that effective lobbying strategies of the Commission, Council, Parliament and new EU regulatory bodies are coordinated between the relevant companies, British MEPs, officials, regulators, trade bodies and ministers at their appropriate level. By bringing together the key players, the minister would provide an opportunity to listen to industry and find out what their key areas for positive action were, while coordinating defensive action in other areas. It would also send a strong signal that Britain was ready for business in Europe and had something to offer as well as something to defend.

In the words of one of our consultees:

The most effective way to engage Brussels is to be proactive in defining the forward agenda. This is something the UK has not been able to do effectively in the wake of the financial crisis.

Recommendation 14: The UK government should demonstrate a cabinet-level determination to lead the European agenda on financial services. This should include developing stronger career structures for UK graduates, civil servants and business people seeking to gain experience of working in the European Commission.

Such a colossal change in approach will take time, but yield major dividends.

Final word

There will always be financial crises. By definition, we won't know where the next one is coming from until it happens; our task in the meantime is to make our system more resilient so we can mitigate the effects when it comes. However, in doing so, we need to make sure that we don't throw out the baby with the bathwater. Britain is good at financial services, providing revenue to the Exchequer and jobs to many people. While there is much that can be done to regulate the sector more effectively, a deliberate policy to 'rebalance' away from the City or weaken it by punitive break-ups, taxation and regulation is not in our long-term interests.

If our recommendations are enacted, not only would the likelihood of a future financial crisis be lessened and its severity reduced, but we would have exploited the experience of recent events to correct some of the weaknesses that have grown up in our financial services sector over time.

We may not ever come to love our bankers, perhaps deep down we do not want to, but we should be able to have a properly informed and open debate on the limits of their operations. By doing so, we can shape the type of financial services sector that we want, and so better realise its potential to contribute to the British economy.

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CITY
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Following the financial crisis and the bailing out of the banks, public opinion of those working in financial services has hit a new low. The public blames bankers for the crisis and the subsequent recession. This suits politicians as it shifts the blame away from them. Indeed, some have argued that there is a need to 'rebalance' the UK economy away from financial services.

City Limits discusses whether such reactions are sensible, or in the national interest. It seeks to improve the clarity of thinking surrounding the banking sector in Britain and offer some policy lessons to be learned from the crisis, as witnessed first-hand by the author as City Minister. Her experience is supplemented by the views of experts – regulators, practitioners and financial services workers – who were interviewed during the course of the research.

This pamphlet argues that the public debate about stability in the banking sector should not be informed by gut mistrust or unease about the financial markets and how they work. Instead the Government should look to understand the root causes of the crisis, to shape the type of financial services sector that we want, and so better realise its potential to contribute to the British economy.

Kitty Ussher is the Director of Demos.

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14 April 2011

Financial Regulation Strategy
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1 Horse Guards Road
London
SW1A 2HQ

Email: financial.reform@hmtreasury.gsi.gov.uk

Dear Sirs,

RE: RESPONSE TO CONSULTATION PAPER CM 8012

Please find attached a response to the recent consultation paper. I ask you to treat the information provided in this response as confidential. The reason for this request is that although I am a member of the FSA's Regulatory Decisions Committee, this response is given in a personal capacity (with the knowledge and consent of the FSA) and I wish to minimise the risk that I could be seen in any way to represent, or be at odds with, the views of the FSA on various matters on which I comment.

Yours faithfully,

Olivia C. Dickson

Enc.

MEMORANDUM

Response to: **A NEW APPROACH TO FINANCIAL REGULATION: BUILDING A STRONGER SYSTEM**

CONSULTATION PAPER CM 8012

From: Olivia C. Dickson

Background

1. I am a non-executive Director and member of the Audit Committee and Remuneration Committees of Investec plc, a non-executive Director of Canada Life Limited, the Senior Independent Director and Chair of the Audit Committee of Invista Real Estate Investment Management Holdings plc and a Trustee Director and Chair of the Risk and Assurance Committee of the Mineworkers' Pension Scheme. I am also a member of the Financial Reporting Council's Board for Actuarial Standards, the Financial Services Authority's Regulatory Decisions Committee (RDC) and the Pensions Regulator's Determinations Panel.

2. Most recently I served as a non-executive Director and Chair of the Risk and Compliance Committee of Aon Limited and prior to that as a Senior Adviser to the Financial Services Authority. Previously I was a Managing Director at JP Morgan, where I served in a number of senior roles including Head of European Derivatives Brokerage. While at JP Morgan, I was a non-executive Director and Chair of the Audit Committee of the London International Financial Futures Exchange.

3. The RDC is the FSA's internal decision maker for important decisions in the enforcement and authorisation areas which result in the issue of statutory notices under FSMA. It is a Committee of the FSA Board and is "Chinese walled" away from the FSA executive so as to meet the separation requirements of section 395 of FSMA. My second three year term as a member of the RDC ends in Nov 2012. Lest anyone think that my response to this consultation might be influenced by self interest, I wish to make it clear that I do not expect to seek re-appointment at the end of my term of office.

4. In my role as member of the RDC I see a wide range of contested cases that pass through the FSA's Enforcement Process. This response is very much informed by my experiences in this role, as well as my previous experience as a Senior Adviser to the FSA and in a wide range of roles as an industry practitioner. However, this is purely a personal response and, although submitted with the knowledge and consent of the FSA, is not to be regarded as being made on behalf of the FSA or RDC or to reflect at all on the views of any of the financial services organisations with whom I am associated. It is for that reason that I have asked for this response to be kept confidential.

5. While my experience informs my perspective, my interest is largely prompted by my continuing roles as an approved person (significant influence function) of a number of regulated entities. I am concerned to ensure that the new regulatory architecture: (i) both holds approved persons accountable for high standards of conduct and also treats them fairly under the law and (ii) provides a regulatory context in which approved persons can discharge their responsibilities effectively and contribute to the strength and stability of a thriving financial services industry in the UK.

6. My focus in this note is therefore a narrow one. I wish to draw to your attention the impact of some the proposals on the individual approved person as opposed to the authorised person (typically firm) or the system as a whole. As the government and the authorities consider the systemic it is too easy to lose sight of the individual.

7. While the concerns of the tax payer and the consumer seem still to be held very much in mind, there is a risk that the legitimate interests of those working in the financial services industry may be neglected perhaps, in part at least, in response to the public mood.

8. This would be short sighted as every successful industry needs to attract and retain high calibre individuals who have confidence in the legal and regulatory framework in which they are required to operate. It is important that individuals working in the industry, particularly those with significant influence, respect the regulator's judgements and see the regulator as accountable, consistent, rational and fair.

9. The issue of accountability and fairness was a major concern when FSMA was enacted and the then Government responded to those concerns by creating elaborate accountability mechanisms and the separation mechanism in section 395, backed up by fresh hearings before an independent judicial tribunal for those aggrieved by important FSA decisions, to counter the populist labelling of the FSA as "judge jury, and executioner".

10. The new regulators will have greater powers than the FSA. The mechanisms described above are therefore as equally relevant today as they were in 2000. They are vital in helping to maintain the confidence of the industry in the fairness of the regulators. In my view there are a number of proposals in the consultation document which could seriously undermine that confidence, particularly the proposal to publish details of Warning Notices (see below at 25).

Box 3.C: Regulatory principles to be applied to both regulators

11. I am firmly of the view that any public authority, particularly one that has the power to regulate the behaviour of individuals and firms, must be mindful of the need to be fair and proportionate in all its actions. Therefore I would suggest that the principle of fairness be enshrined within the regulatory principles.

12. Specifically within Box 3.B on page 47 I recommend that the sixth regulatory principle to be applied to both regulators should be amended so that it reads;

> "the principle that the regulators are <u>responsible for exercising</u> their functions as transparently <u>and fairly</u> as possible"

This principle applicable to the regulator would then parallel those principles regarding the responsibilities of senior management and consumers.

13. Indeed, one might press the point and argue for the simplicity of only three regulatory principles each applying to the three main parties: senior management, consumers and regulators with the principle for the latter being expanded to encompass efficiency, proportionality and disclosure as follows:

> "the principle that the regulators are responsible for exercising their functions in a manner which is efficient, transparent, fair and proportionate paying due regard to the need for appropriate disclosure in pursuit of their strategic and operational objectives."

14. Such an approach would allow an appropriate and useful expansion of the other two principles relating to responsibilities of senior management and consumers. As the current Statement of Principles for Approved Persons (enshrined in APER) amply demonstrates senior management's responsibilities are much broader than mere compliance with the regulatory system (Principle 7).

Box 3.E: PRA's Judgement Led Approach

15. It is entirely unclear from the paper what a 'judgement led approach' to the approval of individuals as approved persons will entail. Given that the reputation and livelihoods of individuals are at stake, this is an area where a requirement for transparency and fairness is paramount. I am particularly concerned that transparency as to how judgements will be made and by whom needs to be at a meaningful level of detail with some mechanism for monitoring.

16. Furthermore, in my view the current system is inherently unfair because individual approved persons are required to put themselves forward for approval before being fully sighted on what views the regulator may have on what particular skills and experience need to be brought to bear for the role in question. This puts the individual's reputation at much greater risk than would be the case if the regulator were required to be transparent in relation to their views on a particular role / individual at an earlier stage in the process.

17. In regard to 'judgement-led' enforcement, it is concerning that at paragraph 3.32 it is noted that;

> "The government is considering whether appeals from judgement-based supervisory decisions should be heard by the Upper Tribunal on limited grounds (those which could be raised on a judicial review)"

The consultation paper uses the loose terminology of “appeal”. Challenge of FSA decisions under FSMA is not by way of appeal but by way of a reference to the Upper Tribunal which then considers the matter afresh and decides what the appropriate action is for the FSA to take. It would be more appropriate to use the more neutral terminology of “challenge”.

18. Many of the decisions referred to, such as the approval of individuals, are likely to have a very significant impact upon the subjects and therefore it would not only seem to be unfair to deny these individuals and firms the opportunity to test the merits of these decisions before an independent judicial tribunal, but it might also be incompatible with Article 6 of the European Convention on Human Rights.

19. There must be a serious risk that significantly limiting the scope upon which certain decisions of the PRA can be challenged, to a judicial review basis, would offend the right that individuals have for their civil rights and obligations to be determined by an independent and impartial tribunal following a fair hearing.

20. Furthermore, as it remains unclear as to who would be undertaking the decision making process at the PRA (the consultation paper is silent on whether or not the principle of section 395 of FSMA will be retained) it is entirely conceivable that the PRA may not have a separate decision maker similar to the RDC, which will take these ‘judgement-based’ decisions. In that case, the unfairness of the absence of a ‘full merits review’ in the Upper Tribunal would be further compounded.

21. The lack of a separate decision maker, which would scrutinise and rigorously examine any proposed action from an independent perspective, is likely to increase the chances of poor decisions being made. If the PRA does propose to have a separate decision maker then this may well improve the quality of the decision making and it would make the system fairer. Nonetheless the suggested limited basis for challenge may well still offend Article 6.

22. There is no reference within the consultation document to whether or not the new legislative framework will retain the principle set out in section 395(2) of FSMA. This section requires the decision maker to be separate from those who are directly involved in establishing the evidence upon which a decision is to be made. Whilst I accept that the absence of any reference does not indicate that it is intended to do away with this principle, it is imperative that this important safeguard should be preserved for both regulators.

Box 3.H: Engaging with practitioners and consumers

23. I am broadly comfortable with what is proposed on engaging practitioners. However, I would like some wording which emphasises the need not only for engagement with firms but also with significant influence function approved persons. The FSA’s recent initiative on NED Forums are filling this gap to a degree and proving beneficial but there is further work to be done and emphasis would help focus the regulators mind and embed this dimension into their thinking for the long term.

24. I am not aware of any mechanism in the current or proposed regulatory framework which requires the regulator to engage with significant influence function individuals or indeed any requirement on the practitioner panel to comment on the regulator's effectiveness in this area. I do believe that corporate governance across the whole industry would be much improved by a more open, honest, substantive, structured engagement between the regulators and the NED approved person community.

Box 4.G: Power in relation to warning notices

25. I am strongly opposed to the proposal to allow warning notices to be published. I believe that it would, in principle, be grossly unfair to the subject of the warning notices and would also not achieve the supposed purpose of publication. The injustice is particularly aggravated when the subject is an individual approved person who is generally more vulnerable than a firm and may well lack the resources to mitigate the harmful effects of publication. I am wholly unimpressed by the toothless and ineffective 'safeguards' which are proposed at 4.89.

26. I am surprised that "many consultation respondents called for a power enabling the new regulators to disclose the fact that a warning notice has been issued." I imagine that any concerns which existed would be around the length of time that those subject to investigation (and therefore potentially a risk to the market) were allowed to continue to operate without affected parties being aware of the risks.

27. Let us be clear, if the regulator is aware that individuals or firms pose a continuing risk to consumers / markets it would be quite improper for the regulator to await the possible publication of a warning notice to protect the interests of consumers. Instead where a risk to consumers is identified the regulator should seek to use the supervisory powers available to it (such as those which are contained in section 45 of FSMA).

28. If the concern is that other firms or individuals may be engaging in practices similar to that which is in issue in the case where a warning notice has been given, then surely there are tools available to the regulators to alert consumers to the possible risks they may be facing without identifying the subjects of the enforcement action.

29. The purpose of enforcement proceedings is to punish those who have breached the rules and provide credible deterrence to those who might otherwise do so. It is not in itself the main tool to protect consumers' interests, as the conduct will have taken place a long time before the warning notice, other tools will be needed to achieve that if the conduct concerned poses a continuing risk to consumers.

30. Warning notices are generally given to the subjects of regulatory proceedings long after their misconduct took place and often long after the decision was taken to appoint investigators within the enforcement division to examine their misconduct. We are often talking about a period of years, not months. A proposal based on the principle of "early publication of enforcement action" should focus on the start of an investigation not the end of it.

31. The Financial Services Act 2010 amended FSMA to allow for the publication of decision notices (before a reference to the tribunal not after the tribunal has made a decision as had hitherto been the case). This was a significant step in the direction of earlier disclosure and in my view, quite far enough.

32. Once a warning notice has been issued the regulatory proceedings will often be over in a number of weeks, following the issue of the decision notice (which as mentioned above can now be published) or a notice of a discontinuance if the subjects representations are accepted. Even complex cases have been disposed of within three months. Therefore it is not clear how the publication of a warning notice will make a material difference to achieving the objective of increasing:

> "…the impact of the regulators' enforcement work by highlighting potential issues to consumers at an early stage and signalling to firms what behaviours the regulator considers to be unacceptable…"

33. It therefore seems undesirable to make such a change, which will potentially have a severe and yet unwarranted impact upon firms' and individuals' reputation, because of the vague idea that it will increase the impact of the work of the regulators. At paragraph 4.89 it is suggested that this proposed new power would;

> "…increase the visibility of the actions it [the regulator] is taking to protect consumer's interests…"

As I have noted above this does not provide sufficient justification for the publication of enforcement action before the regulator will have properly considered the action it is proposing to take.

34. At the heart of the unfairness is the fact that subjects of the enforcement process cannot challenge the case against them, before the decision maker, until <u>after</u> the warning notice has been issued. It therefore is important to note that the RDC often decides to modify the outcome of an enforcement action from that proposed in a warning notice, as a result of representations that are made.

35. In some cases this results in a notice of discontinuance but in most cases where this occurs it will result in a lesser finding than that proposed, for example the enforcement division may have persuaded the RDC at the warning notice stage that the conduct concerned showed a lack of honesty or integrity and proposed a large fine and the prohibition of the individual concerned from working in the industry. This will be before the RDC had seen the subject and made its own assessment of the character of the individual in the light of their written and oral representations.

36. Having considered those matters the RDC may come to the view that the individual, although culpable, was at fault on the basis of negligence or lack of competence and may impose a lower fine and a limited prohibition or no prohibition at all. This is a common scenario as there is a tendency to put the case at the highest level of culpability, and my experience is that preliminary findings of the investigation are not modified significantly when the subject comments on those before the RDC process starts. This is not surprising; the RDC only deals

with contested cases (80% of enforcement cases settle) and in many of those contested cases there is a genuine issue to be determined which is not always clear cut.

37. It would therefore be grossly unfair in the scenario described above that the fact that a warning notice had been issued against an individual proposing draconian sanctions for a lack of honesty would be published. That individual's reputation would be destroyed and it would be difficult to retrieve if the eventual outcome went in their favour, or resulted in a lesser finding. Human nature being as it is, cautious employers may continue to have regard to the original proposals in the warning notice in deciding whether to employ the person concerned.

38. The publication of warning notices is also likely to slow the enforcement process. The consultation document makes clear at the first bullet point in paragraph 4.89 that the regulator will have a discretion as to whether or not to publicise the warning notice. If that is to be the case then the discretion will need to be exercised lawfully and for it to be exercised lawfully the individual or the body making the decision as to whether or not to publish will need to take account of all relevant factors, which should include the views of the subject. The publication of warning notices will therefore introduce an additional stage of representations into the process. This surely can not be consistent with the principle of efficiency.

39. Moreover an outcome which is significantly different from that proposed leaves the regulator open to reputational damage. Where will the regulator be if a warning notice is publicised and effects the share price or operation of a firm and then three months later a notice of discontinuance is issued? The recent events surrounding Gartmore are instructive in this regard.

40. Measured against these risks, the proposal to publish at the end of the investigative process and before the subject has been able to put his case to the decision maker is disproportionate and unfair, and does not achieve the stated objective of 'highlighting potential issues to consumers <u>at an early stage'</u>.

Box 5.D: Approved persons

41. Thinking on the approved persons regime is clearly still at an embryonic stage. For example, while reference is made to the approval of the CEO, nothing is said about approval of the Chairman, NEDs or the Board sub committee Chairs. It is to be hoped that these proposals will be consulted on further, once the thinking is clearer, as this covers one of the most critical functions of both regulators.

42. The FSA's current SIF process sees the regulator aspiring to take a holistic view on the composition and operation of the Board and to link the authorisation process to its view of the strengths and weaknesses of the firm's corporate governance. Furthermore, at the Board level a distinction cannot be made between prudential controlled functions and conduct controlled functions. The Chief Executive is responsible for both and the NEDs for oversight of both. It clearly follows from this that lead responsibility for approval of all SIF approved persons in a dual regulated firm should rest with one or other of the regulators and not be split.

43. In terms of efficiency, consistency, transparency and fairness of the approved person regime it surely makes sense for the FCA to have lead responsibility for the entire approved person regime only consulting with the PRA on SIFs for PRA regulated firms. Given the systemic importance of the PRA regulated firms I can see that the consultation with the PRA on SIF approvals will need to be substantive and in practice may require joint working.

Conclusion

44. I hope that these comments have been helpful to you and have contributed in some small way to heightening your awareness of the impact of these proposals on the individual approved persons who will have to operate in the new system; a system which will in the long term be weaker, not stronger, if appropriate attention is not given at this stage to safeguarding the legitimate interests of honest, competent and capable individuals working in the industry.

ACCOUNTABILITY IN PRUDENTIAL REGULATION OF FINANCIAL MARKETS: A RESPONSE TO HM TREASURY'S 2011 CONSULTATION PAPER, 'A NEW APPROACH TO FINANCIAL REGULATION'

Contents

SUMMARY

This response to the consultation on a response to the HM Treasury's 2011 consultation paper, 'A New Approach to Financial Regulation'[1] comes from Nicholas Dorn, an academic (see annex). The focus of the response is on accountability to Parliament of all aspects of prudential (systemic) regulation. Consideration should be given to direct reporting to Parliament in respect of all aspects of prudential regulation, including regulation of market infrastructure. Routing this relationship through a government department might be as unsatisfactory for the future as it proved in the recent past. There are implications in relation to the Prudential Regulation Authority, for the Financial Conduct Authority and for their relationships with the Bank and the Treasury. The PRA and the FCA should report directly to Parliament, both routinely and in cases of any 'significant regulatory failure'. The fewer stages in, siftings of and renegotiations involved in regulatory accountability, the better, from the point of view of Parliament's ability to satisfy itself on arrangements for financial stability. Such accountability should extent to UK activities in relation to EU financial market regulatory authorities and also international bodies.

[1] http://www.hm-treasury.gov.uk/consult_finreg_strong.htm

1. INTRODUCTION

1.1. The problem

1.1.1. In consultations on capital and other financial markets and their regulation, voices from outside the industry are few and tend not to carry. There are several reasons for this, the first of which is simply the number of regulatory consultations at national and EU levels: consultation fatigue sets in for all but those whose interests are most obviously affected. The second is the argument that many of the issues are 'technical' and have little bearing on the public interest, thus they may be left to industry experts. The third stems from the notorious sentiment, still to be heard in open fora, that politicians lack not only competence but also any reason to be involved in such matters.

1.1.2. However, massive evidence of failure evokes wider attention, political controversy and sometimes disarray (as was the case with the first leg of the financial crisis, 2006-8; and seems to be the case in relation to EU policy on bank and sovereign bailouts, 2010-11). When arrangements fail to deliver the anticipated public goods then their legitimacy comes into and the question of accountability resurfaces. This is the broad context of HM Treasury's consultation.

1.2. Accountability, what for?

1.2.1. The case for accountability of financial market regulators *to Parliament itself* can be made in terms of two broad reasons. First, democratic accountability is a public good, in relation to which exceptions should be made only on very closely argued cases. Second, effectiveness in regulation may be enhanced and safeguarded from cultural bindspots and herd behaviour, if regulators may be challenged by a wide range of political interests, which are absent in networks of regulators and their regulatees.

1.2.2. In relation to prudential regulation for systemic stability, what is needed is lateral thinking ('non-expert', by definition), even heresies, in order not to overcome herd and silo thinking ('expert', 'technical', insider analysis). It is a feature of democratic societies that parliaments offer a means for ensuring such challenges and, when and if quite times return, may be the only means. This is the perspective from which the following remarks are offered.

2. ACCOUNTABILITY OF THE PRUDENTIAL REGULATION AUTHORITY

2.1. Dual accountabilities (1): to Parliament and to the Court of the Bank?

2.1.1. The Treasury's proposals regarding the accountability of the Financial Policy Committee (FPC) and the Prudential Regulation Authority (PRA) are rather loose. At para 1.30 the Treasury document says that 'the FPC, as a policy committee of Court of Directors (the governing body of the Bank of England) will be accountable to Court for the contribution it makes to the Bank's financial stability objective' – as will the PRA regarding 'administrative matters, including its budget and remuneration policy, value for money and performance against objectives'.

2.1.2. And yet (3.53): ‘Parliament, and specifically the TSC [Treasury Select Committee], will take the primary role in holding the PRA to account’.

2.1.3. This calls in question the distinction, if there is one, between on the one hand ‘performance against objectives’ (PRA accountability to the Bank) and, on the other hand, ‘the primary role in holding the PRA to account’ (to be exercised by the TSC, on behalf of Parliament).

2.1.4. Can a man serve two masters? One danger of split accountability, including accountability of the PRA to the Court of the Bank, would be that the Bank/Court would then be in a position to edit the PRA’s reporting and accountability to Parliament if and when a difference of view might emerge between the PRA and the Financial Policy Committee (FPC) and/or the Court of the Bank. Bank co-ownership of the channel of accountability for the PRA opens up the prospect of non-optimal performance and the emergence of an ‘as the Court would prefer us to say’ culture.

2.1.5. Surely, if the PRA’s *primary* accountability is to the TSC, then that accountability should include *performance against objectives*, and also *the contribution it makes to the Bank’s financial stability objective*. The TSC would be capable of asking the Bank for the latter’s views on how the PRA is working on all these matters. The PRA should not be accountable to the Bank except in respect of administrative matters as narrowly defined.

2.2. Dual accountabilities (2): Inflation and stability objectives

2.2.1. That the above concern is a very real one is underlined by the Treasury’s description of the relationship between monetary policy and stability policy: ‘The objectives of price stability and macro-prudential are sufficiently distinct that they should be kept separate and different sets of tools should be used in pursuit of these two objectives’ (2.104).

2.2.3. The relevance for the present discussion of accountability is the following. If the objectives and the tools of price stability and systemic stability (macro-prudential policy) had been defined as being closely intertwined (in principle or in practice), then the accountability paths in relation to these two policies would inevitably had to be at least somewhat intertwined.

2.2.4. Whereas, if the two policies are separate in principle and at least partially separable in practice – as the Treasury says – then so the two accountabilities can take different paths. For example, whilst in respect of inflation outcomes, the Bank is accountable to the Chancellor, this need not be an obstacle to the PRA for its part being directly accountable to Parliament.

2.3. Practical illustration: overall resilience and cross-bank bondholdings

2.3.1. The Treasury proposals make clear that a judgment-based approach is needed, rather than static rules or indicators, because sustainability in relation to any indicator ‘will naturally vary depending on circumstances, for example the position in the economic cycle, and the overall resilience of the financial sector’ (2.31).

2.3.2. This is shown very clearly in the current crisis in the Eurozone (which of course has much wider repercussions), in which weakness of banks in some countries has potentially serious ‘knock on’ effects for banks in other countries. An important transmitter of such problems is the bond market, particularly in circumstances in which a significant proposition of bonds in a troubled bank may be held by other banks. This is known to be one source of the ECB's strongly argued policy that senior creditors should be made whole, even at the expense of exacerbation of fiscal problems for countries/citizens. Take for example the situation in relation to the Irish banks, amongst whose creditors are German banks. In March 2011, the incoming Irish government, whose election policy had been that burdens should be shared, acceded to ECB demands in this respect.

2.3.3. In this connection it is notable that HM Treasury's proposals for the objectives of the Bank of England and its FRC characterise and summarise systemic risk in terms of 'structural feature of financial markets or the distribution of risk within the financial sector, and […] unsustainable levels of leverage, debt or credit growth' (2.11).

2.3.4. The above aspect of HM Treasury's proposals are compatible with a recognition that banks' crossholdings of bonds could be a source of major difficulties, being all of the following: a structural feature of financial markets; an aspect of the distribution of risk; and an unsustainable level (or at least distribution) of debt.

2.3.5. This point has been underlined by Lord Turner (Reforming finance: are we being radical enough? Clare Distinguished Lecture in Economics and Public Policy, 18 February 2011). Even if debt were to convert to equity in times of stress (either through bail-ins required by the authorities or through market mechanisms such as 'CoCos'), still problems would remain. As Turner puts it (page 9), financial systems would only be able to avoid the dilemma of Autumn 2008:

> 'if the following vital conditions are met:
> • If regulators could be confident that those bonds are held outside the banking system; and
> • in addition, confident that the bonds are held by investors who have so arranged their assets and liabilities that they could face the imposed losses without that in turn inducing systemic effects.
> And it may be very difficult to be confident that those conditions we met.'

One might observe that, whilst the second of Turner's conditions might indeed be difficult to ensure (since it would involve monitoring such a wide range of bondholders), there seems no reason *in principle* why bank debt should not be held 'outside the banking system', as Turner puts it. At the very least, it is a discussible idea within public policy. Indeed it is just the sort of idea that one might expect a vigorous PRA to explore further.

2.3.6. Now consider the possible conflict of interest that may arise in relation to the position of central banks, macro-prudential policy on financial stability. Central banks seem interested in and supportive of the debates on bail-ins, CoCos and the like, however they have yet to show (public) interest in the potential for seriously restricting banks' holdings of the bonds of other banks (see for example: Remarks by Paul Tucker, Deputy Governor, Financial Stability: Discussion of Lord Turner's Lecture, 18 February 2011). Historical and institutional commitments by central banks may make it easier to for them to envisage preserving the traditional structure of capital markets than changing them. Bodies such as the PRA, with less baggage, could be less constrained in their thinking.

2.3.7. The case can therefore be made for valuing the separate intellectual capacity and culture of the PRA, which implies that it's accountability should be directly to Parliament rather than via the Bank and/or Treasury.

3. ‘THE REGULATORY SYSTEM AS A WHOLE’

3.1. Is it functioning properly?

3.1.1. In the Treasury proposals (3.54):

- Treasury Ministers will satisfy themselves that the regulatory system as a whole is functioning properly, and will be accountable to Parliament on that basis [and to help Ministers to satisfy themselves, they may commission independent reviews];
- Parliament will hold the PRA publicly accountable for the achievement of its statutory objective and ‘have regards’;
- and the general public, as the ultimate stakeholder in the regulatory system, has a right to information about the operation of the system and the way that the PRA supervises.

3.1.2. The consultation text continues that, in the event of a ‘significant regulatory failure’, the ‘PRA must make a report to the Treasury, which will then lay the report before Parliament’ (3.55). Thus, the PRA would first prepare a report for the Treasury – a process that normally would take place amongst non-public discussions and soundings – and then the product would be laid before Parliament.

3.1.3. It is not immediately clear why the Treasury – the Ministers of which must previously have satisfied themselves ‘that the regulatory system as a whole is functioning properly’ – should be in a position to negotiate the contents of the PRA’s report on ‘significant regulatory failure’. Such a report might touch upon inter-relations between partners and the proper functioning of the regulatory system as a whole (as widely considered to be the case in relation to 2007-8 crisis). On such matters, the PRA might have a view different from that of the Treasury. One may recall that, pre-2007-8, the FSA reportedly felt under pressure from the Treasury (see for example Turner’s February 2009 evidence to the Treasury Select Committee). There seems no guarantee that such a situation could never recur. Hence the desirability of direct relations between Parliament and the PRA.

3.1.4. In short, it would be cleaner and consistent with all the considerations above if both the PRA and the FCA were to report directly to Parliament, both routinely and in cases of any ‘significant regulatory failure’. The fewer stages in, siftings of and renegotiations involved in regulatory accountability, the better, from the point of view of Parliament’s ability to satisfy itself on arrangements for financial stability.

3.2. Regulation of infrastructure: the path not taken

3.2.1 Similar considerations to those above apply to the question of the FCA’s accountability and channels of communication in respect of systemic stability.

3.2.2. Although the FCA’s objective is defined in terms of confidence, it will be ‘solely responsible for the conduct and prudential regulation’ (4.113) of important aspect of market infrastructure: trading platforms, multilateral trading facilities (MTFs) and recognised investment exchanges (RIEs). This is in addition to being the prudential regulator for most firms.

3.2.3. The government’s proposals split prudential regulation of infrastructure between the Bank, for systemically important infrastructure (2.124), and the FCA, for other trading platforms. The PRA does not have such responsibilities. That design may have strong historical roots, however it might be regarded as curious in the context of reform. As the trading infrastructure evolves further in the wake of MiFID and further regulation and market innovation, aspects of systemic risk may migrate into FCA-regulated spaces.

3.2.4. Meanwhile, the Bank's continuing responsibility for regulating infrastructure such as clearing systems might distract it from its role of overall surveillance. The FPC is supposed to be 'a policy committee rather than a regulator' (2.32).

3.2.5. An alternative design could have been to allocate to one and same regulator the responsibility for regulation of all market infrastructure. The PRA, as the primary prudential regulator, could have been a candidate, given its overall role.

3.2.5. What is of concern for present purposes is the implication for accountability. If market infrastructure in all its forms and functions is considered to be systemically important (part of 'interconnectedness'), then arrangements for the regulatory bodies to be held accountable to Parliament – through direct reporting – grow in importance.

3.2.6. Consideration should be given to a *common template* for *direct* reporting to Parliament in respect of *all aspects of regulation of market infrastructure*.

4. ACCOUNTABILITY IN EU AND INTERNATIONAL DIMENSIONS

4.1. EU circles

4.1.1. The 'non-fit' (or possibly constructive confusion) concerning the relationship between the architecture being put place in the UK and that already in place for the EU has been widely commented upon. Regarding UK representation on the European authorities, the government proposes (7.11-7.12) that the PRA will sit on the EBA (European Banking Authority) and on EIOPA (European Insurance and Occupational Pensions Authority), whilst the FCA sits on ESMA (European Securities and Markets Authority), with coordination as appropriate.

4.1.2. The specialist literature, press reports and practical experience indicate that Brussels is a site of intense lobbying. This of course complicates the lives not only of the regulatory committees but also of the Institutions including the European Parliament. It raises thorny issues of accountability, since agenda setting and horse-trading in these networks undeniably are aspects of policy making and regulatory implementation. It is unrealistic to imagine that one could rely solely on the European Parliament to provide oversight of these networking/lobbying issues, as has been recently underlined by an investigation undertaken by the Sunday Times.

4.1.3. Since it is desirable that the UK Parliament has a grasp of the whole picture, no doubt the TSE will continue to explore the European (and international) dimensions. In order to support that, reporting to Parliament by the PRA and the FCA should include, routinely, a frank account of PRA and FCA activities in and on the margins of the EU regulatory authorities.

4.1.4. Consideration could be given to the possibility that such reporting would include an assessment of the industry's lobbying efforts at EU level, at least as those efforts are visible to the PRU and FCA, and an assessment of its possible impacts on policy-formation.

4.2. International activities

4.2.1. Nothing is said directly in the consultation paper concerning accountability of UK financial market regulators when acting on the wider international stage, for example at IOSCO (the International Organization of Securities Commissions). Yet it is at this level that many important policy decisions are made – and sometimes omitted (see for example IOSCO's 2005 scotching of proposals to tighten regulation of credit rating agencies, which in retrospect seems deeply unfortunate). These are not just 'technical' decisions.

4.2.2. An MoU is proposed by the government between the Treasury, the Bank, the PRA and the FCA (7.30). This would cover representation, coordination, consultation between the bodies and means of seeking 'the views of other interested parties, including financial sector participants' (7.30). Yet the text is silent on accountability and reporting in relation to the involvements of UK financial regulators in international bodies.

4.2.3. Stability is internationally as well as regionally and nationally rooted. For this and other reasons, just as the TSE may be expected to continue to explore European dimensions, it may be expected to take a keen interest in the wider international dimensions. In order to support that, reporting to Parliament should include, routinely, a frank account activities in and on the margins of the international regulatory bodies.

4.2.4. Such accountability and reporting could be inscribed in the proposed MoU (7.30).

5. ANNEX

5.1. Author

Nicholas Dorn's research explores relations between public and private interests in financial market regulation, corporate security and transnational governance. He is a UK independent researcher, also teaching global governance in the Erasmus School of Law, Rotterdam. Previously with Cardiff University and before that the NGO DrugScope, he gained a sociology PhD at the University of Kent at Canterbury and other degrees at the universities of Middlesex and London. Recent and forthcoming publications on financial market regulation include the following.

5.2. Selected publications

'The metamorphosis of insider trading in the face of regulatory enforcement', *Journal of Financial Regulation and Compliance*, volume 19, issue 1, February) 2011, pp 75-84.

The Governance of Securities: Ponzi Finance, Regulatory Convergence, Credit Crunch', *British Journal of Criminology*, volume 50, issue 1, January 2010, pp 23-45.

'Regulatory conceptions of unacceptable market practices under three policy scenarios', *Journal of Banking Regulation*, volume 12, issue 1, December 2010, pp 24-47.

‘Ponzi finance and state capture: the crisis of financial market regulation’, pp 235-260 in Van Duyne, P et al (eds), 2010, *Cross-border Crime Inroads on Integrity*, Oisterwijk: Wolf Legal Publishers.

‘Render Unto Caesar: EU financial market regulation meets political accountability’, *Journal of European Integration*, forthcoming (accepted February 2011).

‘Regulatory sloth and activism in the effervescence of financial crisis’, *Law & Policy*, forthcoming (accepted November 2010).

Abstracts of all the above may viewed at http://ssrn.com/author=821888

essex savers
net credit union
Fair Finance for Essex

A new approach to financial regulations – Building a Stronger System

Essex Savers net Credit Union Ltd response to HM Treasury CM 8012:

Background
Essex Savers is an Essex wide credit union providing services across Essex County and two unitary authority districts. We are working to achieve universal access to credit union services, particularly 'face to face' services, through a network of access points, currently 26 in libraries and other easily accessible community premises. We plan to provide online access at access points through the web and continue to explore the possibilities of offering services at Post Offices. Our efforts have been hampered by the lack of funding and resources to have achieved our vision in the expected time scale.

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. Credit unions are already facing increasing costs on a number of items of expenditure, cost of back office systems and banking as they grow in size plus the need for paid professional staff to service the size of operation that would become sustainable and be able to meet regulatory requirements. We are limited on the interest we can charge on loans to members, so limiting our level of income. However, we would not wish to be charging higher rates beyond the current maximum of 2% per month, 26.8% APR as this would be moving away from affordable loans and economic justice and financial inclusion. We are already competitive with banks who are also less willing to lend to all customers. We want to become a real alternative to people from all walks of life so that no-one is excluded.

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

It is our 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 credit unions recognise the need for regulation, the majority which like us are medium to small (there are only a dozen very large credit unions) will find some of the regulations overly bureaucratic and difficult to meet with a mostly volunteer staff. Volunteers, especially retired professionals whose experience and expertise we so need, are being discouraged from serving as directors because of the weight of regulations. There is a continual need for the regulators to ensure that the regulations applied to this group of credit unions is proportionate to the benefits and that the words which appear frequently in the regulations – that they should be "appropriate to the size and complexity" of the firm are applied in practice.

Essex Savers continues its development to become a sustainable social enterprise that is able to deliver its much needed and expanding services indefinitely over the wide geographical area that is its 'common bond'.

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?

N/A

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)?

Response to Question 5 is relevant here also.. Whilst we recognise that as a credit union, we are a deposit taker and therefore must take responsibility for all that this implies, there is very little comparison between a bank and our small to medium credit union with a couple of thousand members. There must be flexibility in how the rules are applied to us to ensure that we are being managed responsibly, whilst recognising our 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 would seem to resolve the queries that were raised 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?

The FSA has operated a good scheme of consultation, although on some occasions it has felt that little account has been taken of the responses it has received. The standing consumer panels for small businesses have been very useful as a way of conveying the views of firms to the FSA and influencing decision making. The Bank and the FSA are holding a meeting in May to consult with all the credit unions about the change of regulator and this is greatly welcomed by the credit unions. 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, although we disagree with the decision not to have a standing consumer panel for the PRA and feel this would be a lost opportunity for the exchange of views.

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 our credit union as we already struggle to meet our core costs which are rising as we make greater use of IT and banking systems to deliver our services more effectively across a wide geographical area. A high fine that is appropriate for a large bank is not appropriate to a small organisation, which is what we are. Fines need to be more flexible and to take into account the size of the firm and the level of services it provides.

In general, when judging the performance of our credit unions, run almost entirely by volunteers, it could be useful to look at grading credit union differently as the current Version 1 or Version 2 only differentiates between the few very large and the rest which differ in size considerably. This could help both regulatory staff and our credit union directors to have a clearer understanding of how the regulations, policies etc apply to us and our 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?

This action seems sensible as the PRA is likely to have greater knowledge about a failing firm and may be able to assist the firm in improving its stability or for a credit union to transfer its engagements or if no alternative to close down in an orderly manner that will not blight the reputation of other credit unions.

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. As 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 feel duel decision making on approved persons will delay in decision making, cause confusion for firms applying for approval and will lead to duplication and extra costs. We feel that one authority should be responsible for those it regulates, but can seek advice from the other where there are any concerns.

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?

We welcome 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.

With regard to 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?

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 stated previously in this response, we and the majority of credit unions are medium or small in size and already face increased costs for fees, insurance, technology, auditing, accommodation costs and 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 previous concerns raised by setting out which authority will be responsible for particular rules or 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?

It seems 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?

An audit by the NAO will strengthen their accountability.

Box 7.C: Consultation question

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

No comment

euroclear

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London, 14 April 2010

A new approach to financial regulation – part two

Dear Sir/Madam

This response is provided on behalf of Euroclear UK & Ireland Limited (***EUI***) which, as you will be aware, operates the CREST system, the UK's securities settlement system. EUI welcomes this opportunity to respond to the consultation regarding the proposed new approach to financial regulation set out in the March 2011 paper (the ***consultation***).

Summary of key responses

In summary, EUI wishes to make the following key responses to the consultation document:

- there remains uncertainty regarding the proposals for oversight of EUI. We would welcome early clarification of this;
- we are concerned regarding the further extension of statutory information gathering powers subject to criminal sanction for regulators. It is not appropriate to use such powers for all regulatory information gathering, as the Bank of England has done. Such powers should only be used exceptionally;
- aspects of the consultation appear to overlook or misunderstand the various regulatory requirements which are currently applicable to EUI (in particular its status as a recognised clearing house). This needs to be clearly

understood to appreciate the potential implications of current European regulatory developments.

We set out below the consultation questions with EUI's detailed responses.

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

As an initial comment we would like to clarify paragraph 2.124, which appears mistakenly to assume that all recognised clearing houses (under Part XVIII of FSMA) are central counterparties (the consultation uses the expression 'central counterparty recognised clearing house'). As HM Treasury will be aware, EUI is a recognised clearing house under FSMA but is not a central counterparty. EUI's status as a recognised clearing house is necessitated by the regulated activities which EUI is carrying out. These regulated activities go beyond those which are carried out by EUI as an Operator under the Uncertificated Securities Regulations.

Regarding the proposals themselves, unfortunately the consultation still does not clarify regulatory oversight of EUI. Although it is implied that EUI will only be subject to oversight by the Bank of England, the explicit confirmation that EUI will not be subject to dual regulation by the Bank of England and the FCA would be appreciated. We refer to the detailed comments in our October 2010 response to the first stage consultation document in relation to the burdens of dual regulation.

Additional clarity would also be appreciated regarding intentions to integrate and streamline oversight of EUI by the Bank of England in relation to its payment systems oversight, recognised clearing house oversight and Uncertificated Securities Regulations oversight roles.

EUI welcomes the current retention of the recognised body arrangements (as noted in paragraph 4.114 of the consultation).

Settlement systems

The consultation document proposes amendment to the Uncertificated Securities Regulations to provide for 'Codes of Practice' to be issued by the Bank of England. EUI is already subject to very detailed provisions in the Uncertificated Securities Regulations, including details requirements in Schedules 1 and 4 to those regulations. Additionally, EUI is subject to the Recognition Requirement Regulations and the REC sourcebook. Further, EUI is subject to the 14 Principles for Oversight of the Bank of England (which in turn are based upon international standards to which EUI is subject) as well as other requirements under the Banking Act. It also complies with the requirements of the Settlement Finality Regulations. It seems entirely unnecessary, disproportionate and complex to introduce the potential for yet another set of requirements with which EUI must comply. We do not see that they could add anything to the existing multiplicity of requirements applicable to EUI. We note that no explanation is provided as to what gaps in the regulatory framework, if any, need to be covered by such an addition. We would therefore suggest that further complexity to the regulatory framework should be avoided and this proposal not taken forward.

We note the intention to extend the information gathering powers of the Bank of England under the Uncertificated Securities Regulations. We comment below (in the context of the similar extension of such powers in relation to recognised clearing houses) regarding the lack of any explanation of the need for such a variation to the existing well established arrangements. These arrangements have functioned well, including throughout the financial crises, and EUI does not see any case for changes has been made.

Additionally, regarding information gathering powers, we are concerned to see a replication of the powers under Part 5 of the Banking Act to the Uncertificated Securities Regulations (and Recognition Requirements Regulations). Without consultation, the Bank of England has utilised its powers under section 204 of the Banking Act to impose statutory information gathering powers, subject to criminal sanction, to all aspects of its regulatory information gathering from recognised payment systems. It is entirely disproportionate to use fraud enquiry standards of statutory investigation in such a day-to-day regulatory context and the approach sets an unusual and unhelpful tone for a regulatory relationship.

Although the Bank of England has suggested taking a relaxed approach to requests and deadlines, this is simply not possible when the requests have been made subject to criminal sanction (for example for failures to respond to the set deadlines). The approach makes information exchange with regulators cumbersome and excessively formal. It has also caused considerable practical difficulty, with the Bank of England needing to make numerous formal adjustments to its information requests because of the excessively rigid framework which it has chosen to impose. The approach is also causing concern with regulators in other jurisdictions.

EUI is committed to continuing its close and continuous oversight relationship with the Bank of England in the same manner in which it has worked, effectively and successfully, with the FSA. We suggest that this approach continues when full responsibility for regulatory oversight moves to the Bank of England. We therefore do not see the need for the further extension of powers of this kind. Alternatively, if such powers are set out in legislation, they should clearly be for use only in exceptional circumstances (eg in the context of specific investigations where regulatory concerns arise) and not for everyday use.

Settlement systems immunity

EUI welcomes the intention to clarify settlement system operator immunity in relation to certain directions issued by the Bank. EUI considers that the opportunity should also be taken to rectify the long standing lacunae in the immunity provisions applicable to EUI.

EUI is provided with statutory immunity under the Financial Services and Markets Act in relation to the discharge of its regulatory functions as a recognised clearing house. However, EUI enjoys no corresponding immunity in performing functions as an approved Operator under the Uncertificated Securities Regulations (in particular where such functions are distinct from, and not covered by the corresponding immunity provisions under, FSMA functions). We would welcome the opportunity to discuss this point further.

Recognised clearing houses

Paragraphs 2.129 to 2.134 appear, as noted above, to be under the mistaken belief the all recognised clearing houses are central counterparties. This is not the case.

As HM Treasury is aware, alongside the EMIR proposals there are also the Securities Law Directive and CSD Regulation proposals currently being considered at European level. All the comments in the consultation regarding EMIR and the potential impact on UK requirements apply equally in relation to EUI as a central securities depository (and the potential impact on UK regulation of EUI caused by European intiatives). We welcome the recognition that it would be premature to make changes to the recognised clearing house arrangements (for CCP and CSDs) in advance of the finalisation of European measures.

However, despite this recognition, the consultation then goes on to propose a number of changes to the recognised clearing house regime. As was discussed with the authorities during the previous round of consultation, no regulatory failings have been identified in relation to recognised bodies. The authorities were not able to identify any situations where information had not been available under the existing 'close and continuous' regulatory relationship between the FSA and recognised bodies. No situation was identified where a sub-optimal regulatory outcome had resulted because of shortcomings in the existing recognised body regime. In the absence of any identified issues or justification, EUI questions the need to revise the well established recognised body arrangements. We do not consider that, just because the regulatory arrangements are being revised for other purposes, the opportunity should automatically be taken to make additional revisions without a clear basis for change.

Coordination

EUI welcomes the commitment to ensure close cooperation between the Bank of England and the FCA.

There is reference to the Bank of England working with the FCA in relation to 'conduct of business issues relating to central counterparty RCHs'. We again refer to our comments above regarding the incorrect 'central counterparty RCH' expression and the focus on EMIR without consideration of CSD issues. We also repeat our comments above regarding explicit clarity that recognised clearing houses will not be subject to dual regulation in relation to 'conduct of business' matters (however that expression is interpreted in the context of the recognition requirements).

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

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

We welcome the commitment to ensure the FCA represents the interests of all UK bodies that have responsibilities which overlap with ESMA's mandate. In particular, it will be essential for the FCA to work very closely with both the Bank of England (as well as, and as distinct from, the PRA). It will also be essential that the FCA coordinates and consults on a regular basis with EUI (as critical settlement infrastructure) and central counterparties.

If you have any queries with regard to the contents of this response, please do not hesitate to contact us.

Yours faithfully

Yannic Weber
Chief Executive Officer

FairPensions

The campaign for responsible investment

FairPensions Response to HM Treasury Consultation, 'Reforming Financial Regulation: Building a Stronger System'

April 2011

Introduction

FairPensions (FairShare Educational Foundation) is a registered charity established to promote Responsible Investment practices by pension providers and fund managers. FairPensions champions greater transparency and accountability to the millions of people whose long-term savings are managed by institutional investors and other professional agents. FairPensions believes that Responsible Investment helps to safeguard investments as well as securing environmental and social benefits.

We work primarily with pension funds and their investment managers, and as such our comments focus primarily on questions relating to the FCA. However, we are concerned to ensure a level playing field for both beneficiaries of trust-based occupational pension schemes and individual policyholders saving with an insurance company. In this regard we also make some comments about the proposed PRA, particularly in relation to the proposed governance and accountability arrangements.

We enclose a copy of our recently-published report, *'Protecting Our Best Interests: Rediscovering Fiduciary Obligation'*. Much of the discussion and recommendations of this report is relevant to the issues considered in this consultation paper. The fiduciary relationship is the foundation of consumer protection in the capital markets, and it is vital that this is put at the heart of the FCA's approach to firms' culture and governance. As such, we refer to relevant sections of the report in our response below.

General comments

We note the government's concern that under the current tripartite system, *"the linkage between firm-level and systemic stability issues has fallen between the institutional cracks"* (para 1.11). We welcome the attempt to address this. However, it is important to make sure that the new system does not create new 'cracks' with dangerous implications for financial stability. In particular, it is as yet unclear who will be charged with responsibility for the important post-crisis agenda of responsible ownership by institutional investors, identified by the Walker Review and currently being overseen by the FRC and FSA through the Stewardship Code. This is particularly relevant to the large number of firms to be regulated by the FCA, which, as the consultation paper notes, *"will not individually pose a threat to financial stability, but… may, individually or alongside peers, play a significant role in particular markets or sectors"* (Box 4.E, p69). The UK corporate governance model places a great deal of emphasis on shareholder oversight as a substitute for intrusive regulatory oversight of listed companies. If this is to continue being the case, it is vital that shareholder oversight itself is subject to clear regulatory supervision. Neglect of this issue could itself pose a significant systemic risk. We would welcome clarification from the government of where this agenda will sit within the new regulatory architecture.

Our other key areas of concern, on which we expand below in our responses to individual questions, are:

- Understanding of fiduciary duties among firms who manage others' money leaves much to be desired. Ensuring that fiduciary standards are achieved in practice is a key part of the challenge facing the new regulatory system, and one which we hope will be at the forefront of the FCA's priorities in particular.
- The present review presents an opportunity to ensure a level playing field between different forms of saving, such as between trust- and contract-based pension arrangements, which are currently subject to completely different regulatory regimes. The role of insurance companies in personal pension provision deserves particular attention.
- The new regulators must do far more than the existing bodies to reach out beyond regulated entities and engage with consumer representatives and civil society. In light of the context for this review, the government must be particularly alert to avoiding the risk of regulatory capture. In this regard we are concerned by the decision to abolish the Consumer Panel for the PRA and to retain only a requirement to consult with industry.
- We welcome the proposed focus on transparency and disclosure, although we think it is important that this remains firmly focussed on its purpose of promoting consumer empowerment and public accountability, and does not become another opportunity for regulatory capture through an excessive focus on transparency to regulated entities. However, given the complexity and long time-horizons of many investment products, we also think it is important to bear in mind the limitations of consumer choice and market discipline in achieving efficient outcomes. Transparency must therefore be supplemented with robust regulatory action.

<u>The Prudential Regulation Authority</u>

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

In relation to the proposed regulatory principles, please see our response to Question 11.

We welcome the government's decision not to require the new regulatory bodies to have regard to the desirability of facilitating innovation. As indicated in our previous consultation response, we agree that in view of the events which have precipitated the current review of the regulatory architecture, this would be wholly inappropriate.

We note the government's concern to ensure that *"unnecessary regulatory burdens are minimised or eliminated"* (para 3.10). Whilst 'unnecessary' burdens are by definition undesirable, we would again refer to our comments in response to Question 11 below, noting the government's stated position that regulations to tackle systemic financial risk will be exempt from the policy of 'one-in, one-out' and the deregulatory thinking that underlies it. Again, the context for this review of the regulatory architecture would make such an approach entirely inappropriate. In contrast to the government's position on regulation in other sectors, there appears now to be widespread political consensus that the problem in financial services has been too little regulation rather than too much. We trust that the new system will reflect this recognition, and are encouraged by indications to this effect elsewhere in the consultation paper.

Question 6: What are your views on the scope proposed for the PRA?

We welcome the government's response to the Treasury Select Committee's observation that the reforms must go beyond banking and that there must be clarity about which firms will be regulated by which regulator.

We are pleased that insurance firms have been identified as a particular area where further work is needed. In the particular case of insurance firms acting as retail pension providers, there will be a need for clear lines of responsibility and effective co-ordination between the PRA and FCA to ensure that key issues, such as investment governance, do not fall between the cracks of the new regulators' responsibilities. Chapter 2 of our report raises the issue of regulatory inconsistencies between trust- and contract-based pension provision. We believe that the present review offers an opportunity to ensure a level playing field between providers and an equal level of governance and protection for all savers, regardless of the form of their pension provision.

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

We disagree with the government's decision not to retain a standing consumer panel for the PRA, and would urge that this be reconsidered. Retaining a requirement to consult with industry but not with those whose capital and financial wellbeing is at stake seems at odds with the government's stated aim of creating a more robust and effective regulatory system. As the government appears to recognise at para 4.68 of the consultation paper, the interests of consumers do not begin and end with consumer-facing activities. The paper notes that making a firm distinction between wholesale and retail activities would be a flawed approach. We believe that making such a firm distinction between the management of systemic risks to financial stability and the protection of consumers is equally flawed. Moreover, requiring the regulator to consult with regulated entities but not with any other stakeholder groups heightens the risk of regulatory capture, which would be fatal to the new regime's ability to fulfil its stated objectives. We urge the government to reconsider this decision and to provide for some form of wider consultation and engagement by the PRA.

Please see also our response to Questions 11 and 12.

The Financial Conduct Authority

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

As the consultation paper points out in paragraph 4.1, restoring trust is crucial to rebuilding a stronger financial system. We therefore welcome the focus on enhancing trust and confidence and the emphasis on consumer protection, including the intention that the definition of 'consumer' will be widely drawn to capture all relevant service users.

However, we are somewhat concerned that the operational objective of *"facilitating efficiency and choice"* is placed ahead of that of *"securing an appropriate degree of protection for consumers"*. At the launch of our recent report on investors' fiduciary duties, the chair of a leading asset management firm observed that the mantra of 'choice' has given consumers thousands of different funds to choose from, but has not delivered the one thing which research suggests savers really want: a system they can trust.[1] We agree that the operation of competitive markets is important for savers. However, as the government recognises at paragraph 4.26 of the consultation paper, the nature of financial products is such that the exercise of consumer choice may be less effective than in many other sectors. As a recent OECD paper pointed out, *"Given the complexity of investment matters and the long horizon of pension matters, expectations [that market forces will lead to efficient outcomes] may seem unwarranted."*[2]

If there is to be a trade-off between the proposed first and second operational objectives, it is therefore vital that the second – effective regulation to protect consumers – takes priority. We trust that this is the government's intention, given the FCA's overarching strategic objective of protecting and enhancing confidence, and the stated aim that it will be a 'consumer champion'. However, the first sentence of paragraph 4.21 could be read as suggesting that the current first operational objective is intended to take priority over the other objectives. Consequently, we would suggest that *"facilitating efficiency and choice"* should be positioned as the FCA's third objective rather than the first and that it be made clear that this repositioning reflects the FCA's intended order of priorities.

These comments are also relevant to the proposed third regulatory principle that *'consumers are responsible for their decisions'* and the fifth principle of '*openness and disclosure*'. FairPensions champions consumer empowerment in financial services, and we therefore agree that *"informed and capable consumers exercising power through market discipline can be far more powerful than regulatory action"* (paragraph 4.26). In particular, we strongly support measures to improve transparency and to ensure that information

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[1] See for example FRSA, '*Tomorrow's Investor*', Dec 2010, p9. http://www.thersa.org/__data/assets/pdf_file/0009/366948/RSA-TI-report-Pensions.pdf

[2] Stewart, F. and J. Yerno, 2008, '*Pension Fund Governance: Challenges and Potential Solutions,*' OECD Working Papers on Insurance and Private Pensions, No 18, OECD publishing

relevant to the fulfilment of investment agents' duties to their clients is made available to the market as a whole.

Conversely, there is a danger in assuming that enhancing the information available to consumers will necessarily be sufficient to protect their interests. As the paper appears to acknowledge, it is impossible to eliminate the information asymmetries that characterise financial services, and therefore to arrive at the conditions necessary for informed consumer choice to be a reliable tool for achieving fair and efficient outcomes. (Paragraph 4.26, however, seems to suggest that the disadvantages suffered by retail customers might be sufficiently offset through the efforts of the CFEB. Much as we support the CFEB, we think that any such suggestion would be quite unrealistic.) Given these circumstances, we consider that the principle *"consumers are responsible for their decisions"* can be accepted only with significant qualifications. Indeed, legally speaking, fiduciary duties apply to agents responsible for managing other people's money precisely because those people are vulnerable in relation to their agents, and the principle of 'caveat emptor' is therefore inappropriate. Our recent report concluded there is a need for a fundamental review of the way fiduciary duties apply to investment intermediaries – particularly as regards the management of conflicts of interest.

While it is of course important that conflicts are disclosed, this is unlikely in itself to protect consumers from the destructive effects of such conflicts, particularly where individual savers are concerned. It is therefore critical that there is effective regulatory supervision of the management of conflicts, and, where necessary, regulatory requirements to avoid situations which give rise to conflicts. In summary, we hope that these regulatory principles will not become the basis for an overly 'hands-off' approach to financial regulation. In addition, if the focus on consumer responsibility is to be meaningful, there will need to be a much greater focus on genuine transparency and empowerment of consumers of all kinds than has hitherto been the case.

Regarding the second principle of 'proportionality', we wholeheartedly agree that regulation should be proportionate. We suggest that there would be benefit in clarifying that this principle does not mean a presumption in favour of deregulation, as it appears sometimes to be interpreted. In this regard we note the statement by BIS, in announcing the policy of 'one-in, one-out' regulation, that *"regulations… to address systemic financial risks will be excluded from the One-in, One-out system"*.[3] We have not seen any subsequent reference to this exclusion in government documentation on 'one-in, one-out'. In the wake of the crisis, a clear break with the discredited 'light-touch regulation' of the past is clearly vital to the FCA's objective of restoring public confidence in financial services. We therefore suggest that there would be value in confirmation from the government that 'proportionality' means just that and does not entail a presumption against regulation, and that it remains the government's policy to exclude regulations of systemic financial importance from its deregulatory agenda.

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[3] http://nds.coi.gov.uk/content/Detail.aspx?ReleaseID=414871&NewsAreaID=2

Finally, we wish to comment on the fifth and sixth proposed principles, those of public disclosure and regulatory transparency. We welcome the principle of transparency in the conduct of the regulator's business, and agree that public disclosure is a vital tool for making the new system more accountable than the last. We would caution that this must translate into a real commitment to public engagement and consumer empowerment, rather than a euphemism for regulatory capture through an excessive focus on being 'transparent' to regulated entities. As a civil society organisation defending the interests of savers, our experience suggests that the existing FSA has much further to go in making its activities "*open and accessible… [to] the general public*" as opposed to the regulated community. We would suggest adding to the sixth principle an explicit recognition that openness and transparency should be particularly focussed on stakeholders beyond the regulated community, such as consumer organisations and the general public.

Question 12: What are your views on the government's proposed arrangements for governance and accountability of the FCA?

We welcome the retention of the Consumer Panel and the fact that the government *"expects the FCA to engage more directly with consumers."* We believe this is an area where much more could be done. As a small charity working to improve accountability to the ultimate beneficiaries of pension schemes, we have found it very difficult to engage with the FSA. In this regard we would reiterate the points made in our response to the previous round of consultation:

Firstly, it is important that the construction of the Consumer Panel ensures that the interests of all relevant consumers are adequately represented, reflecting the wide range of firms that will be overseen by the FCA. In particular, the understandable focus on retail banking and mortgages must not lead to the neglect of pension fund members and insurance policy holders whose assets are entrusted to the capital markets.

Under the present system where panellists are selected through open competition, the only mechanism for guaranteeing this representation is through the panel's engagement with external organisations. This is unsatisfactory, particularly as many organisations representing the interests of ultimate asset owners are not those generally thought of as 'consumer groups', but also include trade unions or civil society organisations. Possible options for overcoming this could include

- Direct representation of consumer representative groups on the panel;
- Requirements that the panel's composition is representative of the full range of consumers affected by the activities of FCA regulated firms;
- Replacing the present requirement in the terms of reference for the Panel to 'have regard to the interests of all groups of consumers' with a more detailed list of groups that ought, *inter alia,* to be considered (including ultimate asset owners such as pension savers); or
- A more formal process for ensuring the panel liaises with all relevant organisations.

We have also observed an acknowledged tendency for the FSA to assume that consultation with the Consumer Panel removes the need for further engagement with consumer groups or civil society, which contributes to the industry bias in public consultations. This is particularly concerning given that the Consumer Panel does not guarantee direct representation of consumer groups. By siloing consumer voices in this way whilst giving regulated entities multiple opportunities to air their own views, the current system may frustrate its objective – and is unlikely to be sufficient for a new body intended to be a "strong consumer champion".

We would suggest either that the role of the Consumer Panel be extended to facilitating wider consumer engagement with the work of the FCA, or that the FCA itself be required to have regard to the need to engage with consumers.

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

We would like to comment on the "proactive and preventative" approach which underlies the proposed new FCA product intervention power. We welcome the enhanced focus on intervention and the recognition that the FCA needs to go beyond a 'point-of-sale' approach. In response to the concerns raised that "earlier regulatory intervention in the product lifecycle could lead to less choice for retail customers" (para 4.59) we would reiterate that wider choice does not benefit consumers when it comes at the expense of trust in the products available. A product intervention power used sensibly and proportionately therefore clearly offers benefits to consumers which far outweigh any reduction in choice.

We hope that the enhanced focus on 'early intervention' represented by the product intervention power will be matched by an equally strong focus on *ongoing* supervision of product governance – including the management of conflicts of interest, the level of fees and charges, and investment governance and stewardship. As chapter 2 of our report observes, these issues are fundamental to outcomes for consumers, but have historically not been treated as consumer protection issues. It is vital that they do not fall between the cracks of the PRA and FCA's priorities.

In this regard we particularly welcome the proposal that *"all firms will be subject to a periodic review of their governance, culture and controls"* (para 4.56). We hope that this will build and expand on the FSA's 'Treating Customers Fairly' initiative, and that it will include a strong focus on firms' understanding of their fiduciary duties to their clients, their management of conflicts of interest, and the extent to which they possess a culture of putting clients' interests first. Again, chapter 2 of our report finds that, although many asset managers describe themselves as fiduciaries, this is not always matched by a sophisticated understanding of what this means in practice, particularly in relation to the duty to avoid conflicts of interest. The fiduciary relationship is the foundation of consumer protection in the capital markets, and it is vital that this is put at the heart of the FCA's approach to firms' culture and governance.

Finally, we particularly welcome the government's recognition that it would be unwise to make too firm a distinction between the regulatory approach to wholesale and retail markets, since *"retail consumers have as much of an interest in the quality of wholesale conduct regulation as institutional investors or corporate clients, given that this is where their savings and pensions are ultimately invested"* (para 4.68). We are pleased to see that *"dealing with these interactions and linkages will be part of the FCA's role as an integrated conduct regulator"*, and look forward to seeing further details of how this will be achieved.

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.**

We wish to comment only on the first of these. Notwithstanding our comments in answer to question 11, we agree that transparency is a vital regulatory tool and a necessary (although not sufficient) condition for a properly functioning market. This applies both to disclosure of enforcement action by the FCA and, perhaps more importantly, to disclosures by firms themselves to consumers and to the market as a whole.

Our report raises, in particular, the importance of disclosures on conflicts of interest (chapter 2, pages 35-43) and on the voting and engagement activities of firms authorised to manage investments (chapter 6, pages 121-123). These are both vital to giving consumers visibility on how their agents are serving their best interests. Our own research has found significant weaknesses in leading asset managers' disclosures on their policies to manage conflicts of interest.[4]

Transparency is important for individual as well as for institutional clients. It is disappointing that the FSA appears to take the view that there is no point requiring firms to provide certain information to retail customers since they are powerless to act on it. For instance, the new requirement to disclose a firm's commitment to the Stewardship Code has not been applied to retail investment providers, on the basis that "i*n practical terms, we see limited potential for individual retail investors to direct the stewardship practices of asset managers."*[5] While we agree that individual consumers may find it more difficult to exercise their consumer power, the answer to this must be to supplement transparency with effective regulatory supervision. We hope that this more robust approach will be the one taken by the FCA.

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[4] FairPensions, December 2010, '*Stewardship in the Spotlight*'.

[5] FSA, November 2010, *Handbook Notice 104*, p20

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 effective co-ordination between the PRA and FCA will be vital to the success of the new regulatory framework. Whilst endorsing the government's objective to allow the PRA and FCA flexibility on how they engage with each other rather than laying down an overly bureaucratic and inflexible process, we do believe there would be value to setting out some of the substantive issues where co-ordination will be necessary and which must therefore be included in the Memorandum of Understanding. We trust this is the government's intention at para 5.13 of the consultation paper. As indicated above (see general comments), we believe that the exercise of shareholder oversight is one area where co-ordination between the PRA and FCA will be important. The regulation of insurance companies is another (see response to question 6).

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13 April 2011

Emil Levendoglu
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Dear Emil,

Response to HMT paper "A new approach to financial regulation"

We very much welcome the consultation the Government is undertaking on the new regulatory structure. We understand the reasons for the Government's approach and welcome the intention to publish a draft Bill for further scrutiny. The proposals will set the regulatory landscape for the next ten years; it is a complex project with many potential pitfalls. We would, therefore, echo the words of the Treasury Select Committee when they said that it is more important to get this structure right than to meet a fixed timetable.

In addition there are a number of policies and documents which are central to the changes which have not yet appeared. For example we need to be clear how the cats-cradle of interest in the regulators are going to face up to the ESAs in Europe. All concerned need to be able to judge the whole picture and to have time to think through the implications.

FIL is a member of a number of trade associations and has been interacting with them on their responses but there are a number of issues where we would like to add particular emphasis.

The consumer interest

The new structure, taken together with the structure of European regulation, runs the risk of not focussing sufficiently on the consumers' direct interests. The test of this new structure will be whether it improves the lot of citizens by protecting them from the consequences of major financial failure and by improving their experience of financial services personally.

With the PRA being primarily responsible for banks and insurance companies and the FCA for "agency" firms, such as asset managers, IFAs etc the responsibility for the end consumer will be split and the primacy of their concerns may fall between two stools.

This will not be helped by the structure of the ESAs in Europe. When consumers come to the financial services market they treat it as a whole; nothing in the proposed structure matches that expectation.

There are other features of the proposals which tend in the same direction. Because the PRA will always pay prime attention to financial stability it might keep in existence a firm responsible for major consumer detriment in circumstances where the FCA might let a firm with similar behaviour fail.

We are also very concerned that the Markets Division of the FCA is to hold the UK seat in ESMA. FIL has an interest in the markets work of ESMA but again it betrays insufficient weight being given to the consumer interest rather than that of financial services players.

Just as there is an overarching body on the prudential side, the FPC, we would recommend a joint standing committee of the PRA and FCA to ensure that appropriate attention is paid to consumer issues.

Competition

Again, we would endorse the TSC's view that enhancing competition should be a statutory objective of the FCA. That would help to ensure that the FCA has a strong consumer focus and that this part of their work is not subservient to the markets side.

Competitiveness

We also believe that the FCA should have a statutory objective relating to international competitiveness. At this time it is imperative that we put in place a range of measures to ensure that the UK can continue to compete in the global marketplace. The UK has a strong financial services industry which contributes to the success of the broader UK economy. The world is becoming increasingly competitive and every market participant needs to work hard to maintain our current competitive position.

FIL works with nearly forty regulators round the world and some of them successfully manage to work with national and European rules, maximise investor protection and seek to promote their own domestic industries. We fear that the PRA will ignore this important equation unless they are required to pay attention to it.

FCA Supervision

We note that the FCA will set out its regulatory approach but we would like to comment on a number of issues.

The FCA will be regulating firms which, in the majority of cases are agency firms which do not act as principal but act on behalf of others. The detriment that such firms can cause is usually related to conduct of business or operational issues. A proportionate regime for such firms would look very different from the current "Arrow" procedures which appear to us to be disproportionately detailed and expensive for the risks under consideration. It is also said that the supervision will be "judgement-led," this will require a different calibre of staff from the generality in the FSA at the moment.

Moreover FIL's business is predominately carried out in UCITS funds which are authorised by the FSA and have their own internal checks and balances.

On the other hand we welcome the FSA's recent Product Intervention paper which, together with some other points set out below, has a strong possibility of preventing or minimising consumer detriment in future. The FCA will need to consider how it can intervene when non-UK products are passported into the UK. This may need intervention at the European level.

The Ombudsman

It is sensibly suggested that the FOS should have a duty to report to the FCA the first signs of detriment appearing. At the moment they refuse to liaise sensibly with the FSA although the new Co-ordination Committee is a step in the right direction. In addition their terms should be altered to ensure that they judge cases in the light of FSA rules and guidance at the time of the alleged loss. If they wish to go further they must consult the FSA and set out in public their reasons for not following the FSA. At the moment they make entirely independent judgements without regard to FSA rules or guidance nor to the common law. Some criticise them for that whereas they are merely following their duty under FSMA. This issue is very important if simplified advice is to get off the ground

The FSCS

The recent events surrounding Keydata suggest that there is much wrong with the role and accountability of the FSCS. We commend the submission from the IMA in this regard.
In particular the FSCS chose to put Keydata investors in a better position than if there had been no regulatory breach. This cannot be right.

They could have paid out actual income and capital losses and liaised with the FSA on seeking redress from other liable intermediaries. Also they did not liaise with the industry on a recovery package until it was too late. This course of action and the previous suggestion would have better served those investors who had invested more than the £48,000 compensation limit.

There will be a review of the operations of the FSCS and it may be that the rules they operate under left them no discretion, but we doubt it. There also seems to be no appeal mechanism nor any accountability either to investors or to the industry whom they can tax.

There are a number of ways forward. The Scheme could become a subsidiary of the FCA/PRA. The scheme could be formally accountable to the TSC. They should certainly be given a statutory objective to consider the consumer interest in broad not narrow, legal terms.

There also needs to be careful consideration of the split relationship with the FCA and PRA.

Early publication of warning notices.

It is suggested this should be the norm. We believe it should be the exception and only after the agreement of the RDC, and the full Board of the FCA. Over-publication of warning notices will hit consumer confidence in the whole savings industry not just in offending firms. We should note that we consider the retention of the RDC a vital part of the checks and balances on the FCA. It is extremely difficult to hold the FSA/FCA accountable for mistakes they make which cause loss to those they supervise; therefore it is important that there be in-built checks on enforcement actions in particular.

Transparency

The paper expects regulated firms to be open and transparent and talks about transparency from the new regulators. We suggest the board meetings of the regulators be public when making rules or policy, something akin to SEC public hearings. Certainly the minutes of the boards should reflect the arguments made as do the minutes of the MPC.

Panels

A number of panels will be made statutory. One is to be a Markets Panel. This must contain 50% buy-side representation. The buy-side voice has traditionally not been considered sufficiently, although it has improved recently.

Captive insurers

FIL has a captive insurance company purely to handle pension investments tax efficiently. We would hope that the PRA/FCA can come to a pragmatic understanding so that all of FIL's UK operations can look to a single regulator, the FCA.

Costs

We note that the impact assessment, although necessarily tentative, assumes a non-trivial amount of costs, £250mn, with ongoing increases in costs for regulators and regulated, with little certain benefit. We would recommend these figures are re-visited, perhaps by the NAO after the changes have been implemented.

Yours sincerely

Philip Warland

Philip Warland
Head of Public Policy

A NEW APPROACH TO FINANCIAL REGULATION: CONSULTATION ON BUILDING A STRONGER SYSTEM

Response by the Finance & Leasing Association

Executive Summary

- Around 100,000 firms are currently licensed to provide consumer credit. The Government has recently proposed that regulation of these firms be transferred from the Office of Fair Trading (OFT) to the new Financial Conduct Authority (FCA). If this happens, consumer credit will be one of the sectors most significantly affected by the proposed new approach to financial regulation, as it is not currently regulated by the FSA under the Financial Services and Markets Act (FSMA). It therefore faces fundamental change: not only to the scope of regulation, but also to the rules under which it does business. The cost (in time, money and other resources) of change on this scale must not be underestimated.
- Around 40% of consumer credit is provided by firms which are not banks. And around 40% of all current credit licence-holders are sole traders. A proportionate regulatory regime will therefore be essential if the UK is to retain a diverse and competitive consumer credit market, delivering choice to a wide variety of consumers.
- The proposed new regulatory powers must therefore be subject to detailed cost-benefit analysis, both individually and collectively. Without this, their impact on firms and on consumers will remain unclear, with real potential for adverse unintended consequences.
- The publication of Warning Notices by the Financial Conduct Authority before regulatory action is completed would cause unjustified reputational damage for firms, and confusion for consumers. We strongly oppose this approach.
- The Financial Conduct Authority and the Prudential Regulatory Authority should be required to implement common approaches to authorisation, rule-making, reporting and supervision to ensure that firms regulated by both are not disadvantaged by duplicate and costly requirements.
- The proposed approach to product intervention runs the risk of inhibiting innovation and could have wider implications for financial exclusion, including by limiting the range of services offered to consumers.
- The FCA should have a clear mandate to deliver consumer protection, but should not be a “consumer champion”, which would jeopardise its role as a fair and impartial regulator.
- The timetable and resources required to deliver the proposed changes must be realistic. The end-2012 target date suggested is impracticable and should be reviewed, so that Government and the affected firms have a sensible timeframe in which to deal with these radical and potentially complex proposals.

Introduction

The FLA represents the UK consumer credit, motor and asset finance sectors. Our members include banks, building societies and many other types of independent finance company. Last year, they provided £50 billion of consumer credit to their customers, a third of the UK total. This included credit and store cards, personal loans, store credit and second charge mortgages. FLA members also provided £18 billion of motor finance, which funded half of all private new car sales.

On 17 February 2011, the Government published the Consultation Paper (CP) *A New Approach to Financial Regulation: Building A Stronger System,* which sets out the proposed remits and interrelationships of the new Financial Policy Committee (FPC), Prudential Regulatory Authority (PRA), and Financial Conduct Authority (FCA).

The Government has separately proposed to transfer consumer credit regulation from the OFT to the new FCA, and to apply to it a completely new regulatory regime based on FSMA. The FLA has responded separately to these proposals, which raise a number of important concerns.

Assuming these proposals were to go ahead, the regime described in the February CP would have significant implications for the UK's 100,000 consumer credit providers. While the CP itself is silent on the matter, it is important that the Government keeps it firmly in mind.

Around 40% of consumer credit is currently provided by institutions which are not banks. Looked at another way, out of the current 100,000 firms licensed by the OFT to privde consumer credit, 40% are sole traders. It is therefore hugely important that the new regime is proportionate. This is essential if the UK is to continue to benefit from a highly competitive consumer credit market which delivers a broad range of products to many different consumer groups.

The proposed new regime also needs to take into account the fact that the consumer credit sector is currently well-regulated, and was not a major factor in the recent economic crisis. Over the past five years, the regulatory regime for consumer credit has been extensively overhauled and enhanced, including via a major revision of the Consumer Credit Act, much of which was implemented in 2008; the new EU Consumer Credit Directive, implemented in February 2011; and the 2010 regulatory changes affecting credit and store cards. This package of new regulation is still bedding in. It should form the basis for any new framework intended to apply to consumer credit, to ensure that the benefits it has brought customers are not lost.

We look forward to working closely with the Government to ensure the new framework works well for both consumers and lenders. The remainder of this response focuses on the questions in the CP which would be relevant to the consumer credit sector if responsibility were to transfer to the FCA.

Financial Policy Committee

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

- The FLA supports the FPC's overall objective of protecting and enhancing financial stability, with a specific focus on preventing systemic risk. We also agree with the point made in the CP that the FPC will need to strike a balance so as to secure a safer financial system without compromising sustainable economic growth in the long term.

- In exercising its powers, we are pleased to see that 'proportionality' will be one of three factors (the other two being openness and international law) to which the FPC must have regard. Proper consideration of the cost of any action required by firms when compared to the benefits likely to be delivered will be essential for both large and small companies.

- We are extremely concerned by the suggestion that the FPC will not be required to consult or produce a formal cost-benefit analysis (CBA) prior to making a recommendation or direction or using macro-prudential tools. We believe consultation and proper CBA would be essential in establishing whether any proposed action was proportionate and justified.

- For example, one of the suggested macro-prudential tools is capital requirements. Consumer credit firms are not currently required to hold regulatory capital, and its introduction would therefore have major implications for the sector. Capital requirements are appropriate to those markets where the fundamental risk lies with the depositor or saver. With consumer credit, the fundamental risk rests with the lender. A requirement to hold regulatory capital would be unnecessary, and would drive many firms from the market. It would also severely affect smaller and/or low-risk firms.

- To avoid the potential for firms being regulated by more than one regulator, we agree that companies should not be directly regulated by the FPC and that any regulatory action should be channelled via the PRA or the FCA. This will provide certainty for both regulators and companies.

- One of the proposed functions of the FPC is to make public pronouncements and warnings. In the past, companies have often found it difficult to keep track of speeches by the FSA which have been used to set out regulatory requirements which must be complied with. This has been highly unsatisfactory, and has created a disjointed approach to regulation – not least because such announcements have sometimes been subject to misinterpretation and misunderstanding. If the FPC makes speeches or announcements containing important regulatory information (e.g. requiring action by firms), the FCA and PRA should be required to advise companies directly.

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

- No**.**

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

- Overall, we support the proposed governance and accountability measures.

- Paragraphs 2.91 to 2.93 of the CP outline a process whereby the FPC may make a recommendation or a direction to the PRA and/or the FCA. In both cases, time constraints might limit the opportunity for consultation where the risk to financial stability is considered significant. While we accept that there might be extreme circumstances where action would need to be taken quickly, our concern is that if the FPC is not required to undertake a CBA, and then the PRA and FCA themselves do not consult properly, the full impact (and proportionality) of such action will not be considered in advance, with the real potential for unintended consequences for both lenders and consumers.

- We do not understand why the Chief Executives of the PRA and the FCA will both sit on the FPC, but only the former will have voting rights. As both the PRA and FCA will be involved in prudential regulation, both should have voting rights on the FPC. Otherwise the authority of the FCA will be diluted.

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

- No

Prudential Regulation Authority

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

- The FLA agrees with the PRA’s strategic and operational objectives, and we welcome the fact that ‘proportionality’ will be part of the regulatory principles. But it is disappointing that both the FCA and the PRA will not be required to consider competition, diversity and innovation. While the CP states that these factors will be considered by the FCA and PRA, this surely cannot be guaranteed unless there is a specific requirement so to do.

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?**

- We have not commented on this question as it does not directly relate to consumer credit providers.

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?**

- In connection with rule-making, the CP states that the PRA will make greater use of principles and that the rules will include short statements so that firms understand the rationale behind the rules and the desired outcome. But in practice, what most firms want is certainty, so they can ensure that they are compliant. Any rules should therefore be clear from the outset, without the need for detailed guidance on what they mean in practice.

- With regard to enforcement, we firmly believe that the Upper Tribunal should consider appeals on the 'full merits review' and not on the limited grounds linked to a judicial review action.

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

- The proposed framework appears workable.

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

- We agree with the accountability measures 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?**

- Effective accountability measures must be in place between the PRA and the firms it supervises if the regime is to be effective. The CP refers to consultation on the PRA's Annual Report, including whether it has achieved its objectives. While it is always useful to monitor the effectiveness of past action, there should also be a draft Annual Plan which sets out proposed priorities for the year ahead, and which should be subject to prior consultation with the industry.

- The CP (Paragraph 3.66) says that the PRA will be obliged to consult on new rules, except where to do so would be ‘prejudicial to its objectives’. We believe that the PRA should always be under an obligation to consult in advance of the implementation of new rules. The PRA will also have ‘flexibility’ in deciding what arrangements to follow when consulting the industry, as long as the arrangements are transparent. Firms should have certainty on how the PRA will consult and the arrangements should, as far as possible, be consistent every time the rules might be subject to change.

Financial Conduct Authority

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

- The FLA supports the strategic and operational objectives of the FCA, and we welcome the fact that the FCA must discharge its functions in a way which promotes competition. But we remain of the view that the FCA should have a statutory objective to promote competition; a view supported by the House of Commons Treasury Committee. The CP states that competition will remain a primary issue for the FCA in discharging its operational objectives. But the operational objectives only allow consideration of competition where it is ‘compatible’ with them. This could lead to dilution and provide a ‘get out’ clause.

- The CP (Paragraph 4.3) notes that conduct regulation under the FSA had not received the attention and focus required. But this has not been the case for consumer credit regulation under the OFT. The conduct of OFT-regulated firms has not frequently been called into question. And the regime has – as described above – been materially enhanced in the past five years, not least by the introduction of the new Fitness Test, which determines whether firms are suitable to hold a consumer credit licence in the UK.

- Paragraph 4.4 of the CP refers to the FSA’s current Discussion Paper on *Product Intervention*. At the moment, this relates to financial services which currently fall within the remit of the FSA. But if consumer credit regulation does eventually transfer from the OFT to the FCA, it will be important to ensure that consumer credit products are considered carefully as part of the current consultation exercise, so as to avoid inappropriate measures being applied on a ‘cut and paste’ basis at a later date.

- The CP says that point of sale regulation has not been effective in preventing large-scale detriment among retail customers. Again, this has not been the experience in the consumer credit market. Recent enhancements to the regulation of the point of sale – especially with regard to oral and written disclosure – have played a major role in ensuring that consumer credit customers can make informed borrowing decisions. The consumer credit sector has not experienced the 'waves of consumer detriment' outlined in the FSA's Product Intervention Discussion Paper.

- The CP says that the FCA is to be a 'consumer champion' as well as 'an impartial regulator from whom firms and consumers can expect fair treatment'. This is a clear conflict of interest. Instead of being a consumer 'champion', the FCA should have an objective linked to the promotion of consumer protection. This would be compatible with its need to be fair and impartial. The Treasury Select Committee also opposed the FCA having a role as consumer champion and considered that it would be 'inappropriate, confusing and potentially dangerous'.

- We are pleased to see that the FCA's regulatory principles will include 'proportionality', and that consumers must take responsibility for their decisions.

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

- The governance and accountability measures for the FCA appear acceptable. But there must also be accountability to regulated firms, and hence requirements similar to those suggested for the PRA. The FCA should therefore publish a draft Annual Report on its work over the previous year as well as a draft Annual Plan setting out its proposed focus over the forthcoming year.

- Paragraph 4.47 of the CP says that the FCA will be the prudential regulator for around 18,500 firms. But if consumer credit regulation transfers to the FCA, this number will be much higher, as there are currently 100,000 consumer credit licencees. This could have major implications for how the FCA is able to regulate both conduct and prudential requirements. The resource implications are very great.

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

- The FLA agrees that firms should have proportionate measures in place to review and evaluate new products, including their cost and distribution strategies, as well as monitoring how their products operate in practice. We also agree that any requirement for pre-approval would stifle product innovation and lead to delays in delivering services to consumers. But the proposed powers to ban products or make them unenforceable would have adverse implications for lenders, especially if action is taken some time after a product has been brought to market, and perhaps achieved significant consumer take-up. There would also be the risk of business failure where firms only offer one product.

- Banning products, and the sanction of unenforceability, are both extreme measures, which could exceed the scale of potential disadvantage to consumers. Such sanctions could have a number of unintended consequences, including restricting product innovation and diversity in the UK financial services sector. The end result could be that lenders offered very low-risk standard products to a restricted group of customers, so as to avoid any potential for retrospective regulatory action affecting existing lending.

- We will be responding separately to the FSA's Discussion Paper, arguing that a proportionate approach should be taken which does not restrict lenders both in both the services they provide and in the consumer groups to whom they lend. The FSA's consultation on product intervention must be allowed to run its course and the outcome should not be pre-judged by the Treasury's separate consultations on regulatory reform.

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?**

  - The FLA accepts that regulators need to have sufficient market information about the sectors they oversee and the firms they regulate in order to be effective. However, at this stage it is unclear how far the FCA's new legislative powers of disclosure will go and what safeguards will be in place. Until this is clarified, we remain concerned that all firms could be subject to an onerous duty of disclosure, and about how this information will be used (and perhaps published) once collated.

  - With regard to financial promotions, we do not believe that the FCA should publish details of a Written Notice until after the Upper Tribunal has considered any appeal. If an appeal is successful, there seems to be no proposed mechanism for conveying this information to consumers, if a Written Notice has been published. The appeals process also needs to be efficient and without protracted delays, so cases can be resolved quickly.

  - The FLA is strongly opposed to the FCA's publishing Warning Notices until any appeals process has been exhausted. To do otherwise could leave consumers confused and unsure as to what action they should take if they have an account with the company in question. A situation could arise where consumers take action in response to a Warning Notice linked to a company and are then confused (and potentially disadvantaged) if a Notice of Discontinuance is subsequently issued.

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?

- Many of the examples given in the CP concern dealing with competition problems, rather than promoting competition through appropriate regulation. The latter should be an important aspect of the new regime. We look forward to seeing the more detailed proposals on competition which are promised, and we support the suggestion that the FCA would be able to make a Market Investigation Reference to the Competition Commission, if necessary. The ability of the FCA to agree binding commitments with the industry instead of a formal referral would also be useful.

- The current super-complaint process works well. The consumer groups which bring such complaints usually have a strong pool of evidence on which to base decisions on whether to lodge a complaint. If the FCA's Consumer Panel were to have similar powers, it is unclear whether it would also have sufficient direct consumer evidence on which to bring well-researched complaints.

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?**

  - Not applicable

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

- The FLA agrees that it will be essential for there to be effective coordination between the FCA and the PRA, especially in connection with dual-regulated firms. This should avoid unnecessary duplication and costs.

- The proposed legal duty to coordinate activities seems to be focussed on mutual consultation. More detail is required on how this would work in practice: what formalities would apply to the timing of any consultation?; what reporting should be required after the consultation has finished? For example, if the FCA does not accept the PRA's views, an explanation of the reasons should be provided.

- We agree that the MoU should be reviewed annually to assess where improvements can be made. This will be especially important in the early years.

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?

- Paragraph 5.23 of the CP refers to the FCA taking advice from the PRA in its role as the regulator with greater prudential expertise. It is unclear whether this would also apply to the prudential regulation of firms which may not come within the PRA's remit. We do not think it should extend this far. The point should be clarified.

- It is stated that the PRA may exercise its veto over the FCA in cases where they cannot agree, and the FCA's actions might lead to the disorderly failure of a firm. Further clarification is required on what would then happen to the firm in question. Would the FCA be forced to take alternative action?

- The power of veto must only be used sparingly. If this proves not to be the case, a review of the interaction between the FCA and the PRA should be triggered to examine how they could work more effectively together.

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?

- The majority of the 100,000 currently licensed consumer credit firms would, if transferred to the FCA, be FCA-only regulated and so would have to apply once for approval. For those credit firms which would be dual-regulated, the alternative approach (which would provide for one authority being charged with processing each application with the consent of the other body) would appear to be more cost-effective and efficient. It would mean that the data linked to the application would be considered in a streamlined way and without duplication of time and resource. If consumer credit firms do come within the FCA's remit and require authorisation, the sheer numbers involved mean that this type of approach will be necessary to ensure that resources are applied effectively.

- We agree with the proposal that both the PRA and the FCA will be able to vary and remove a firm's permission in line with the FSA's current procedures in this area.

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

- Consumer credit firms are not currently subject to 'approved person' requirements and so – if they transfer to the FCA – this would be a significant additional feature and cost of the proposed new regulatory framework. The imposition of such a process also needs to be considered for proportionality in light of the 100,000 firms who will need to undergo this procedure and the type and extent of the risk involved. In consumer credit, the risk lies with the lender and not the consumer so once the loan has been made, the chances of significant consumer detriment are much more limited than for an investment product. We therefore seriously question whether approved person requirements are appropriate in the consumer credit market.

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

- The FLA supports the proposal that the FCA will have oversight of firms which have passported into the UK and that the FCA will be responsible for the conduct of UK-authorised firms which are passporting financial services outside the UK.

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

- The CP refers to rule changes being accompanied by a CBA of their effect on mutually-owned organisations, which will allow the Government to assess whether the regulation treats diverse business models appropriately. The transfer of consumer credit regulation from the OFT will result in a broad range of very diverse organisations coming within the FCA's remit. The proposed CBAs should also look at the impact on the many other (non-mutual) business models with which the FCA will then have to deal.

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

- How and when the power of veto can be used by the PRA over the FCA must be clear at the outset, to ensure that it is fair and does not place the FCA at a disadvantage or subject to challenge as being the inferior regulator.

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.**

- We have not responded to this question as it has little direct connection with consumer credit firms.

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 have no comment, as these provisions are mainly based on legislative requirements.

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

- The provisions relating to insolvency proceedings appear sensible.

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

- We welcome the fact that the CP accepts that the FCA and PRA will need to use their resources efficiently to keep costs down. This reinforces the benefits which could be derived if the FCA and PRA were to have common procedures in respect of authorisation, reporting, rule-making and supervision.

- Smaller firms will be most affected by the increase in regulatory fees, which will be exacerbated by the fact that consumer credit firms do not currently pay the central levy for the Money Advice Service (formerly CFEB). The incremental impact on firms should not be underestimated. A staged approach to increased fees should be taken to avoid a contraction in the market as firms struggle to meet higher regulatory costs. Increased costs for firms will also have an impact on the cost ultimately charged to the consumer.

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

- The FSCS does not apply to consumer credit, as the risk lies with the lender and not the customer.

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

- The FLA supports the proposals in the CP for increased transparency between FOS and the FCA, which will be important in identifying potential trends in complaints. FOS should be required to put any necessary additional resource in place to avoid the extensive delays which can occur under the current arrangements. The FLA, together with the other major financial trade associations, have jointly written to the Financial Secretary to the Treasury outlining further action we believe is required in connection with FOS. The main points of the letter are:

(i) The role of the FOS within the new regulatory architecture needs to be clearly defined in statute, including its relationship with FCA. This is particularly important as the FCA will have the power to draw on wider sources of intelligence in identifying risk, including information provided by the FOS, as part of its new approach to conduct regulation. Greater clarity on the role of the FOS should provide some confidence to firms that if they comply with FCA regulations on products and sales that they will not face retrospective interpretations of the rules;

(ii) The FOS should be removed from the process of determining regulatory issues with wider implications – this should be the responsibility of the FCA or the Upper Tribunal;

(iii) The FOS should not have the right to prevent firms from seeking resolution of test cases in the court where a complaint raises important or novel points of law;

(iv) As a statutory body with a turnover of over £100m, the governance and accountability of the FOS needs to be enhanced. Including the FOS within the remit of NAO audits is a positive first step, but we suggest the FCA should conduct regular reviews of its overall operations, policies and procedures. This should not compromise the operational independence of ombudsmen when adjudicating on individual cases;

(v) The FOS should be required to consult with stakeholders before issuing policy notes or guidance;

(vi) CMC regulation by the Ministry of Justice has been delivered with the best of intentions, but has never been properly resourced. It needs to be strengthened – perhaps brought within the FCA remit – and options should be explored for CMCs to contribute to FOS funding. CMCs should also be responsible for reimbursing lenders' FOS fees (without recourse to the customer) where FOS considers that the complaint has been spurious.

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

- The FLA supports the proposals for strengthened accountability.

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

- The FLA agrees that it is essential that there be effective coordination between the regulators on international reforms which could affect the financial services sector. The MoU between the Treasury, Bank of England the PRA and the FCA will need to set out in detail who does what and when, to ensure early participation in the discussion of international regulatory changes.

April 2011

Financial Ombudsman Service

A new approach to financial regulation: building a stronger system

Consultation response from the Financial Ombudsman Service

14 April 2011

Introduction

The Financial Ombudsman Service was established under FSMA in 2001. Its statutory function is to resolve, quickly and with minimum formality, disputes between financial businesses and their customers, as an informal alternative to the courts. It replaced a range of predecessor statutory and voluntary ombudsman schemes covering particular financial industry sub-sectors, such as banking, insurance and investments. The service is free to consumers, and is funded by the financial businesses it covers.

Workload

In 2010/11, the Financial Ombudsman Service handled a record 1,012,371 consumer enquiries and resolved 164,899 cases. Almost half of the new cases the service received in 2010/11 were about just one topic – payment protection insurance. During the year our user satisfaction rates improved, as did the time taken to resolve cases.

Consultation

In *A new approach to financial regulation: building a stronger system* the Government asked for stakeholders' views on its proposals relating to the Financial Ombudsman Service, including on its proposals on transparency and accountability. The Financial Ombudsman Service welcomes these proposals.

We welcome the Government's intention that the Financial Ombudsman Service should remain an operationally independent alternative dispute resolution service and that the FCA should take on the FSA's existing governance functions in relation to the service. We welcome too the Government's recognition that the statutory function and responsibilities of the ombudsman should remain quite distinct from those of the regulator. In that context, we believe that the Government is right to set out ways in which the ombudsman service can share the results of its work in a transparent way, for example through the publication of ombudsman decisions, and to set out ways in which the existing accountability mechanisms can be strengthened further.

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12 April 2011

Dear Mark,

Financial regulation – the FRC's contribution

I am responding on behalf of the Financial Reporting Council (FRC) to the proposals set out in the consultation paper, "A new approach to financial regulation".

We welcome the proposals to establish a clear and robust framework for the relationships between the Financial Policy Committee (FPC), the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA), and the recognition that the new structure should have strong links with other bodies which undertake relevant regulatory functions – including the FRC. The financial crisis highlighted the need for close co-operation between regulators at national and international level. It also demonstrated the links and interdependencies between markets – particularly the credit and capital markets - and therefore the need for regulators of these markets to work together.

The FRC has the lead role in corporate governance, investor stewardship, corporate reporting, audit, and actuarial practice – all of which support the quality of governance and reporting in the financial services sector. For some aspects of reporting and audit we undertake a monitoring and enforcement role through the Financial Reporting Review Panel, the Audit Inspection Unit and our Accountancy and Actuarial Disciplinary Board. Our scope includes major entities in the financial services sector – and their auditors - and thus interacts significantly with both the PRA and FCA. Our role in overseeing the regulatory activities of the accountancy and actuarial professional bodies is also relevant.

There are four key issues we would like to flag in relation to our future work with the PRA and the FCA.

Firstly, it is important that the new legislative and organisational framework provides the necessary gateways for the exchange of information between the FRC, the new bodies, and government departments.

The effectiveness with which the FRC, PRA and FCA can pursue concerns about the quality of reporting or audit in the financial services sector depends on our ability to share information that has been uncovered in our respective supervising activities. At present there are legal impediments to this and we should explore how these can be resolved. A mutual willingness to use the gateways is also important and we believe that appropriate concordats on how the bodies should work together on a strategic and day to day basis should also be agreed.

Secondly, it is important that there is effective collaboration between the FRC and the UK Listing Authority, particularly in relation to the attention paid to good corporate governance after companies have joined the market. This is an area in which both HM Treasury and BIS have an immediate interest.

Thirdly, it is crucial that the UK deploys its considerable influence and expertise in relation to corporate governance, accounting and auditing issues as effectively as possible within the new European framework for financial regulation. This means putting forward coherent and persuasive UK proposals for debate in the European Securities Markets Authority and the banking and insurance bodies. We believe, for the reasons set out above, that the FRC is able to contribute appropriately to policy development, the debates with the European Commission and Parliament that help shape EU proposals, responses to consultations, and – crucially – technical discussions with ESMA (and the other bodies) that will determine the Authorities' decisions. There is an important and parallel process of influencing other Member States, who will be establishing their own arrangements in response to the new European regulatory architecture – to which we can also contribute. The FRC's Financial Reporting Review Panel is already a full – and very active - member of the European arrangements for considering enforcement decisions and common reporting issues relevant to the consistency of IFRS reporting across the EU. Building on the statements in your consultation document we should like to be assured that the FRC will continue to represent the UK on reporting enforcement matters and will be able to attend Committee discussions on audit and governance either as a full or as an observer member.

Fourthly, we support the proposal to give the Financial Policy Committee a broad power to give advice on financial stability and make recommendations directly to the financial sector, to other domestic bodies such as the FRC and to relevant international and European institutions.

We work closely with the markets – investors, business, auditors and actuaries and other professional advisers – to address a range of regulatory issues. In addition to the standard-setting, monitoring and enforcement functions we have traditionally discharged, we promote the quality of governance and reporting through thought leadership, backed by thematic studies and other communications with the markets. In the wake of the financial crisis we led debates about the responsibilities of boards and audit committees in managing risk, of investors in holding boards to account, and of auditors in providing a level of assurance on which investors and others can reasonably rely. We have proposed enhancements to company reporting and audit to deliver greater value to investors, and have launched an inquiry (led by Lord Sharman) to identify lessons for companies and auditors addressing going concern and liquidity risks. Most recently, we have made clear that we will give full weight to the recommendations of the House of Lords Economic Affairs Committee on auditors in considering how to strengthen the value of audit to capital markets.

In view of the potential value of this work to the Financial Policy Committee and the proposed ability of the Committee to give us advice – which we would feel a strong obligation to take extremely seriously – we propose that the FRC has observer status at the FPC.

In conclusion, we welcome the proposals and are engaging with HM Treasury and the new regulatory authorities to ensure that, as the new system settles in, the FRC plays an active role in ensuring its success.

Yours sincerely,

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Response to A new approach to financial regulation: Building a stronger system, April 2011

Executive Summary

We welcome HM Treasury's second consultation paper on the reform of the regulatory system and the opportunity to shape a more effective, focused regulatory system that delivers good prudential regulation and enhanced consumer protection. The consultation paper expands on many of the issues that we identified in our previous response[1]. We approve, in particular, of the following aspects:

- The opportunity that arises from a twin peaks structure to have a dedicated consumer protection agency focusing on conduct issues.
- A strengthened focus on competition, with the proviso that this could be made clearer and supported by full competition powers.
- A greater commitment to transparency, provided this is accompanied by rules that support reputational regulation and greater accountability of the regulator.
- The judgment-based approach to regulation, which will allow the regulator to intervene proactively to prevent detriment before it has materialised.
- A product intervention power to stop products that are not fit for purpose and have the potential to cause detriment.
- A commitment to have regard to wider sources of information and to engage more directly with consumers.
- A continuing role for the FSA panels.

However, there are still some significant regulatory gaps in relation to financial inclusion and access and in relation to non-financial businesses that rely heavily on banks. We encourage further consideration of the way in which the draft bill should effectively address these weaknesses. We propose that the FCA's consumer protection operational objective be amended to read: "securing an appropriate degree of protection and access for all consumers" and that the power of super-complaint be widened to include organisations representing small and medium non-financial businesses.

Our outstanding concerns centre on governance and accountability of the regulatory regime and the comparative powers of the regulators. We propose the following mechanisms to achieve greater co-ordination, accountability and balance between the PRA and FCA while preserving a circumscribed power of veto in relation to the disorderly failure of firms:

1. The PRA veto should be exercisable only in relation to the disorderly failure of a firm or firms and not in relation to "wider systemic instability"; if there were concerns about systemic instability the right of veto should lie exclusively with the FPC.

[1] A new approach to financial regulation: judgement, focus and stability. The Financial Services Consumer Panel Response to CM 7874, October 2010.

2. To resolve veto disagreements not associated with a general financial crisis, the PRA or FCA should have access to the FPC, which would arbitrate.
3. The PRA should be subject to a “have regard” to minimise the adverse effects of its activities on competition.
4. There should be an effective managerial incentive structure and an internal audit process to encourage co-operation and the free flow of information between the PRA and FCA.
5. The Treasury Committee should report annually on the FCA and PRA, and how well their activities are co-ordinated.
6. The FCA should submit bi-annual reports to BIS and HM Treasury, comparable to the bi-annual stability reports by the Governor of Bank of England.
7. The PRA and FPC should be formally required to consider representations from the Consumer Panel.

We note the concurrent consultation on the regulation of credit and hope that at the next stage there will be an opportunity to bring these consultation processes together. It is important to consider the implications of bringing the regulation of credit into the FCA as part of the changes set out in this document.

<u>Bank of England and Financial Policy Committee</u>

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

   In its deployment of macro-prudential tools, the FPC will be required to take account of the effect of its actions on the capacity of the financial sector to contribute to UK economic growth and to be proportionate, but is absolved from the requirement to conduct a formal cost-benefit analysis. Absent from these proposals is a sufficiently explicit requirement for the FPC to consider the impact of its actions on consumers' welfare. Instruments such as loan-to-value caps or enhanced regulatory capital requirements introduced, for example, to avert an emerging housing market bubble may be effective in stabilising the financial system, and therefore of general benefit to consumers, but may in addition limit consumers' access to financial services and raise their cost. It is not self-evident that the proposed constitution of the FPC would provide adequate breadth of experience and independence of thought to ensure that these specific consumer concerns were taken into account.

   We believe that the FSA should be required pro-actively to engage with the interim FPC to subject macro-prudential tools to a rigorous cost benefit analysis in order to evaluate the effect of each tool on financial stability *and* consumers' welfare. This preparatory exercise would facilitate the selection of preferred macro-prudential tools that would contribute most to financial stability while inflicting least collateral damage on consumers, judged in terms of the impact on the availability and cost of financial services. Except in circumstances of immediate crisis, we would also expect the FPC, once fully operational, to consider in consultation with the FCA the consumer welfare implications of macro-prudential interventions.

   We particularly support the use of information disclosure as a macro-prudential tool. There should be a constant flow of information from the regulators to the FPC, and the power to direct the regulators to require firms to disclose certain information is an important supplementary power.

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

   The FPC will be a sub-committee of the Court of the Bank. In addition, a majority of the members and the Chairman will be drawn from the executive management of the Bank. In our view this does not provide the necessary checks on the decisions taken by the Bank's executive management. We think that a majority of members should be from outside the Bank. These non-Bank executives should be properly supported and resourced to guard against the phenomenon of "group think". In normal circumstances this will provide the necessary independence to consider actions proposed by the Bank, the PRA and FCA and decide on the best course. In an emerging crisis, where decisive action is important, it is extremely unlikely that the independent members will overrule the advice of the bank's executive. In that respect the experience of the recent crisis has been reassuring.

   .

The Monetary Policy Committee (MPC) provides an example of greater transparency and accountability of operations within the Bank of England and, allowing for the different functions, could be a model for the FPC.

The MPC goes to great lengths to explain its thinking and decisions. In addition to the publication of the minutes of meetings and the discussion leading to decisions they also record the votes of the individual members of the Committee. The Committee has to explain its actions regularly to parliamentary committees, particularly the Treasury Committee. MPC members also speak to audiences throughout the country, explaining the MPC's policy decisions and thinking. This is a two-way dialogue. Regional visits also give members of the MPC a chance to gather first-hand intelligence about the economic situation from businesses and other organisations. We would encourage the FPC to adopt a similarly transparent approach in its engagement with stakeholders.

The Panels have traditionally had a worthwhile dialogue with non-executive members of the FSA Board, providing information and particular perspectives, and we propose that this ongoing dialogue should continue with the FPC. We believe that a formal relationship with the Panels, similar to that proposed for the FCA, would be a useful addition to the governance arrangements for both the FPC and PRA. This could be achieved as part of the MoU between the FCA and the FPC and PRA.

Prudential Regulation Authority

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

(i) Strategic and operational objectives

Competition

The omission of the former general duty to have regard to the impact of regulatory activity on competition does not affect the FCA, as long as it has its enhanced competition objective, but does raise the danger that regulatory intervention undertaken by the PRA may have a damaging impact on competition and consumers' welfare. Concentration or a regulatory preference for larger institutions raises concerns about barriers to entry and creates the risk of imperfect competition. It is no doubt easier for a regulator to regulate a small number of firms with a similar operating model. If the PRA only focuses on financial stability it may lose sight of the long-term impact of its activities on the competitive structure and behaviour of financial firms.

This danger was taken so seriously that Cruickshank (1999)[2] proposed the FSA be responsible for making the trade-off between regulatory and competition outcomes in financial services. He proposed that the FSA be given a *primary* competition objective to minimise the anti-competitive effects of its regulatory activity.

[2] Cruickshank, D. (1999), *Competition and Regulation in Financial Services: Striking the Right Balance*, July.

We are not minded to propose a Cruickshank principle for the new twin peaks structure. It may be difficult for the PRA itself to make a competition-stability trade-off, and the elevation of competition to a primary PRA objective could lead to muddle and possibly to industry gaming of the regulatory rules.

We nevertheless believe that a competition check is required on the PRA's activities. The existence of the FCA provides a primary check, but the power balance between the two organisations as proposed would not produce satisfactory consumer outcomes. We appreciate the strengthening of the duties of the authorities to consult and co-ordinate and believe that this could be better delivered if there was an obligation on the PRA to be mindful of the potential for adverse impact on competition when making its decisions. We therefore propose adding the current "have regards to" applying to the FSA to the PRA's regulatory principles:

"the need to minimise the adverse effects on competition that may arise from anything done in the discharge of the PRA's functions".

<u>Co-ordination of business model analysis</u>

The PRA and FCA will have a different regulatory emphasis because of their different obligations but they should have a common way of analysing business models to serve both sets of objectives. To avoid duplication and waste, we propose there should be a common template for the gathering of information on firms' business models and effective co-ordination of supervisory visits from both PRA and FCA.

(ii) Regulatory principles

We address the common regulatory principles under question 11.

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)?**

We welcome the adoption of a judgement-led supervisory approach by the PRA and see this as significant in moving the regulator towards a more proactive approach in which activities that pose unacceptable risks are curtailed in advance of evidence of widespread detriment. We believe that, although the FSA has had extensive powers, its supervisors have been unduly hampered in their efforts to impose regulation swiftly by the arguments about the interpretation of rules and principles.

In circumstances where the regulator is acting in good faith and observes due process the grounds of review to the Upper Tribunal should be on those limited grounds that apply to judicial review, and not a full and costly review of merits. There needs to be efficiency, certainty and finality of decision making.

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

and

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

The PRA will effectively act as a division of the Bank. The governance reflects that. We would reiterate our concerns expressed in answers to questions 3 and 6; that the FPC needs to have a majority of independent members, in order to provide effective oversight of PRA decisions which could have a wider impact on stability, economic growth and consumers' welfare, and that the FCA proposed advisory panels could provide a broader perspective and useful advice in the area of business model sustainability and competitive effects.

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

The proposed mechanisms for engagement of the PRA with the wider public or on broader issues are inadequate. Parliamentary scrutiny will not be sufficient or even alerted to issues with the regulator if there is no provision for greater public scrutiny. Leaving accountability to complaints after the event will not play the crucial role of providing information for decision making.

The Panel supports the continued use of consultation in rule making but believes that more comprehensive cost-benefit analysis could materially improve the quality of rule changes proposed by both the PRA and the FCA. We would like to see much more emphasis on the quantification of *consumer* costs and benefits, in addition to the regular appraisal of the compliance and other costs faced directly by industry. These enhanced cost-benefit analyses need to be better resourced and provide robust and credible outcomes that are seen by both industry and consumers alike to be fully independent of regulatory policy making

The decisions of the PRA and its supervisory work have the potential to impact significantly on consumers, because of the power of veto over conduct regulation, the interactions between conduct and financial stability (eg the decisions taken to deal with an asset bubble) and the potential for detrimental practices to be endorsed in the name of financial stability (eg in a PPI type situation). It is vital that consumer interests are represented in its discussions. The presence of the chief executive of the FCA on the Board is not sufficient in our opinion. As already raised in relation to the FPC, we would like to see the Panels having a relationship with the PRA Board, as now with the FSA, which would enable us to be aware of forthcoming items on their agenda and the ability to submit observations and comments on issues which are being discussed where the experience of the people on the Panel may be relevant. This has been achieved through the requirement in s10 & 11 of the FSMA for the FSA to establish and consult Panels of consumers and practitioners and, for the panels to be able to raise issues formally with the Board and require them to respond. This process has never been used formally but, through the MoU under which the Panels operate, it has been possible to discuss issues and provide advice which has improved the debate on the Board.

In addition to external consumer input, the Consumer Panel currently plays a role within the FSA in relation to both prudential and conduct issues and also provides advice on matters applicable to both such as consumer engagement. The Consumer Panel works to advise and challenge the FSA from the earliest stages of its policy development to ensure the FSA takes the consumer interest into account. Members of the Panel encompass a broad range of relevant expertise and experience. The Financial Services Act 2000 provides that the FSA must have regard to any representations made to it by the Panel.[3] Translation of the formal recognition of the Consumer Panel to the PRA and FPC would enable early input and identification of possible consumer impacts or prudential regulation.

Financial Conduct Authority

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

Whilst we understand the desire to have a single focused objective the wording around the strategic and operational objectives and other related matters could be clearer in allocating responsibility and authority. We broadly support the objectives subject to the following considerations:

Consumer protection

It is our view that a conduct regulator must focus on consumer protection and delivering good consumer outcomes. Protecting and enhancing confidence in the system must be clearly linked with the consumer protection objective.

Competition

We support the greater emphasis on competition, both through the operational objective and in that the FCA must discharge its general functions in a way which promotes competition. The importance of competition to consumers has been re-emphasised in the recent Treasury Committee report on Competition and Choice, the BIS consultation paper on the competition regime and the Independent Commission on Banking's interim report. In particular we endorse the sentiments of the BIS consultation that it is necessary to maximise the ability of the competition authorities to secure vibrant, competitive markets that work in the interests of consumers and to promote productivity, innovation and economic growth. The paper proposes developing the regime's ability to resolve and deter the competition restrictions that do more harm to competition, consumers and to economic growth and providing the regime with the tools and flexibility to make proportionate and focused interventions. In allocating the FCA a competition function its powers and authority have to be equivalent to those of the sector regulators.[4]

[3] FSMA 2000 s10(4)
[4] BIS, A Competition Regime for Growth: A consultation on options for reform, March 2011, p6.

We therefore propose that the competition operational objective be strengthened as follows:

"The FCA must, wherever appropriate, promote effective competition that improves consumer outcomes in retail and wholesale markets."

Financial inclusion

In our response to the original consultation we proposed a "have regards" to the desirability of promoting financial inclusion, and for the new regulator to have an effective toolkit that will enable it to act appropriately as an economic regulator, including the power to intervene on charges. Although the current consultation paper rejects the suggestion that the FCA should have regard to the promotion of financial inclusion, it helpfully confirms that the FCA's efficiency and choice objective and the proportionality regulatory principle provide the mandate for the regulator to address financial inclusion (para 4.3).

It is no longer possible to function outside of the financial services system, not only in relation to transactional services but increasingly in pensions and insurance, as responsibilities in these areas pass from the Government to consumers. Access to financial services is a precondition to functioning in society and needs to be intermediated. Other sector regulators have a range of social duties and for most of these this includes a primary duty to further the interests of consumers.[5] The FCA should be no different in this respect and clear recognition needs to be given to its role in intervening to secure financial inclusion.

In order to better reflect the role of the regulator in this area we propose the consumer protection operational objective be amended to read:
"securing an appropriate degree of protection and access for all consumers".

Financial crime

We understand the proposal is to treat financial crime as a 'have regard'. Whilst there have been re-assurances that this is not a downgrading of the previous objective, it may be seen as such by both consumers and industry. If so, it would send an unacceptable message that the transition from FSA to FCA would lead to a reduction in efforts to combat financial crime. There may also be an adverse impact on the retention and recruitment of talented, public-service minded individuals who could earn much more in the private sector. We believe there is a need to be more explicit about the requirement to reduce financial crime, to assuage those who fear, possibly incorrectly, that the goal has been downgraded, and to safeguard this goal against future changes in regulatory emphasis.

The Panel further understands that in this context, the FCA will interpret financial crime as covering money laundering and insider dealing, and not as covering directly consumer related issues such as the unauthorised provision of financial services. We

[5] As above, p 72

would not want to see financial crimes that directly affect consumers drop off the agenda as non-priorities

We are aware that cuts to funding of the Serious Fraud Office and to the justice system will affect the ability of other bodies to pursue enforcement and prosecutions. It is therefore crucial that adequate emphasis, enforcement powers, and resource is provided to the FCA in this area.

In the absence of any assumption of such responsibilities by the SFO, the constabularies, or perhaps the proposed new Economic Crime Agency, the need to combat financial crime should be added as an FCA operational objective.

(ii) Regulatory principles

The position of the industry in relation to principles has the capacity to undermine their intent and application.[6] Authority and clarity are needed through the making of rules. There is recognition in the FSA of the difficulties here:

> "I have previously said that I expect the FSA to move towards more detailed prescription...Effective enforcement and redress requires clarity of responsibilities and a process that can stand up to clear external scrutiny. It is thus inevitable that a conduct regime will lean more towards rules than principles as this is a necessary consequence of its focused objectives"[7]

<u>Consumer responsibility</u>

The principle of consumer responsibility needs to import the provisos associated with the reasonableness of this expectation contained in s 5 of the current FSMA and referred to in the consultation paper at 4.17, which take into account the differing degrees of risk, the level of experience and expertise that different consumers may have, the product they are buying, the channel through which they are buying it and the needs that consumers may have for advice and accurate information. It needs to be linked with an increase in accountability to consumers.

If it is suggested that consumers are given greater responsibility then this needs to be married with greater accountability to the consumer. In a market where some products are essential to functional daily life or future planning, and where competition is weak, direct accountability mechanisms for the consumer are poor. The regulator therefore plays an important role in working on the consumer (and industry's) behalf to ensure products are safe, fit for purpose and promote rather than inhibit competition by way of unnecessary complexity. Well targeted product intervention would increase the confidence of all classes of existing and prospective consumers in the products purchased. The US Consumer Protection Act recognises this through the setting of product standards. The Panel's research suggests that the great majority of people expect to take responsibility for their own actions, but that

[6] In particular see the BBA's judicial review action of the FSA's policy statement on PPI, lodged October 2010.
[7] Hector Sants, Speech to BBA conference on the Financial Conduct Authority, March 2011.

they also expect to be treated fairly, which means to them that their expectations are met.[8]

Duty of care

To balance the principle of consumer responsibility we support the inclusion of a principle that authorised firms have a duty of care to their clients, (in a similar way to the fiduciary duty established under the Dodd-Frank Act). The principle would not create new obligations but replicate the common law principle.

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

FSA has traditionally had strong market expertise and performed its markets role well, but could have done better in consumer protection. Throughout the FCA there is a need for consumer protection experience, expertise, resource and emphasis, but particularly at Board and Executive Director level.

We welcome a greater commitment to engaging more directly with consumers and in particular the proposal to "establish a robust and effective mechanism for understanding both consumer needs and preferences, and equally importantly, ensuring consumers feel that their views are both listened to and taken into account in the FCA's decision-making."[9]

The Consumer Panel forms an important sounding board at the early stages of policy development and decision making, providing a consumer oriented perspective before proposals are crystallised and subject to public lobbying. The endorsement of the Panel in the latest paper and by way of responses to the previous consultation supports our role in relation to conduct regulation.

The Panel is just one of the ways that the FCA should secure good information and advice and the appropriate input from those with relevant skills and experience. Clear and regular relationships with consumer advocacy groups, as well as a means of engaging with consumers more generally and with particular groups such as vulnerable or disadvantaged groups, will continue to be important. This engagement needs to be both structured and embedded throughout the sections of the new organisation.

It would improve decision making and provide more focus and accountability if the FCA were to commission specific consumer research and impact assessment to look at the health of the market, such as a regular consumer protection and well-being report along the lines of the annual Ofcom Consumer Experience report. In addition we support the proposal to better utilise existing sources of information such as the information from FOS and the requirement to consider and act and be seen to act, on issues the FOS brings to its attention,

[8] Opinion Leader for the Financial Services Consumer Panel, Consumer Perceptions of Fairness within Financial Services, June 2010
[9] Hector Sants, Speech to BBA conference on the Financial Conduct Authority, March 2011.

The CFEB will continue to contribute to the FCA's objectives through its financial capability work and the MOU between the organisations should be designed to ensure there is an obligation to exchange information and consult on issues that are likely to impact on consumer outcomes.

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

We welcome the intervention power in relation to products but for it to be effective it must be extended to include powers for temporary and permanent action in relation to mis-selling and unfairness issues. In extending these powers the regulator will be able to prevent situations such as the continued mis-selling of PPI over many years and the mounting consumer detriment that has resulted in the flood of complaints to FOS. It is the regulator's role to take preventative action rather than place the onus on individuals to challenge after detriment has occurred. The extension of the approach to wholesale markets is significant in providing better protection for pensions and savings.

We also support a broad range of intervention powers, including banning products, reviewing cost models, setting compliance standards, stress testing, periodic reviews of distribution and performance, and selective pre-approval of products. The provision for unenforceability of contracts in breach of the intervention rules is an important addition in providing protection for consumers during enforcement action. The intervention power also requires support through appropriate remedies applied by the regulator. The FCA must be willing to exercise the revised s.404 powers and restitution orders and should consider further whether additional collective redress mechanisms are necessary.

.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.**

<u>Transparency and disclosure as a regulatory tool</u>

The inclusion of regulatory principles on transparency and making information available signals good intentions on behalf of the new regulator. We are concerned however that these principles are still subservient to s.348 and that, without amendments to s.348 or the making of rules under s.349 to support disclosure, the current cautious approach will persist. For example the regulatory principles will not provide the regulator with the authority to publish complaints data, which are currently published courtesy of a voluntary agreement between industry and the FSA. In order to support the regulatory principles we recommend that further consideration be given to the amendment of the definition of confidential information and to the making of rules specifically supporting the public interest in availability of information.

Reputational regulation is an extremely efficient and effective way of regulating provided that consumers have the information they need in good time and in an appropriate form. Information itself is not useful unless it is relevant and contextualised. The US has long required companies to file detailed financial information as a matter of course through the Securities and Exchange Commission in order to provide all investors with access to certain basic facts about an investment prior to buying it, and so long as they hold it.

Just as regulatory failure reports may include the disclosure of information where this is justified in the public interest, it should be possible to disclose information in the course of investigations to support the regulator's objectives and principles where there is a clear public interest in avoiding detriment and enabling competition.

Financial promotions

We support the new power to direct firms to withdraw misleading financial promotions. The Panel recommends that the withdrawal power applies also in relation to unfair practices such as targeting vulnerable consumers or those for whom the product may be unsuitable. Those who repeatedly fail to comply with the financial promotions rules or commit serious breaches should be required to submit copy prior to advertising for approval by the FCA.[10]

Warning notices

We are also concerned as to the extent of information that will be provided if it is the intention only to publish that a warning notice has been issued and not the warning notice itself. For this to be an effective tool for consumers the publication needs to identify the firm, the reasons for the warning notice, the products or practices involved, and the time period being investigated.[11] We support the publication of the warning notice and relevant information.

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 support both a market review power and a market investigation power for the FCA and consider that the regulator should have full concurrent powers as with other sector regulators including being able to prohibit cartels and abuse of dominance. The conduct regulator will in effect be performing a similar role in relation to what have now become utilities in both transactional services and pensions and savings.

The FCA will have an in depth understanding of the industry and should be able to conduct an investigation and form a view, try to seek a resolution and then ultimately

[10] The Advertising Standards Association committee of Advertising Practice Code may require persistent offenders to have some or all of their marketing communications vetted by the CAP Copy Advice team until the ASA and CAP are satisfied that future communications will comply with the Code.

[11] The Australian regulator, ASIC, issues infringement notices where they believe a firm has contravened the Act. Firms are given an opportunity to remedy the contravention though complying with the infringement notice requirements within 27 days of being notified. At the end of 27 days, whether there has been compliance or not, ASIC may publish the notice.

refer a matter to the Competition Commission. For example, the issues surrounding the emergence of packaged bank accounts would be dealt with quite differently by a financial services regulator with competition powers.

The super-complaint power is posed as an alternative to the market investigation reference power (MIR), when it serves a different purpose. An MIR power can be used by the regulator to secure a legally binding commitment; whilst a super-complaint power can be used by the Consumer Panel or other interested organisations to bring a matter to the attention of the regulator and/or the competition authorities. We therefore support the inclusion of both powers.

The Panel would benefit from access to the super-complaint power in that our power to require responses from the regulator is weak under the current s.11 of FSMA, and does not do enough to draw attention to issues that warrant further investigation. It is also important that an organisation with guaranteed resources is able to initiate super complaints where others might not have the flexibility to use or divert resources in this way. The Panel itself may require more resources in order to carry out this function effectively.

The extension of the super-complaint power to other qualified entities is also vital. The Panel is in a different position from consumer advocate organisations in that it is part of the regulatory system and maintains a relationship where early warnings and information are exchanged with the regulator in order to influence policy at the formation stage, rather than at the public lobbying stage. The super-complaint power needs to be widely available to consumer advocates and interest groups subject to the application provisions of the Enterprise Act. Consumer organisations represent different interests and the potential needs to be there to raise issues about anti-competitiveness and unfair practices that apply to all consumers or segments of consumers.

The super-complaint power under the Enterprise Act should be more broadly defined if it is to be applied effectively to financial services. The current definition of "consumer" excludes those carrying on a business.[12] In the present context, this definition would leave exposed those non-financial businesses that are not given protection by other relevant legislation, such as that for consumer credit, by competition policy, by redress mechanisms such as the Financial Ombudsman Service, or by conduct regulation.

In practice, all but the smallest non-financial enterprises are left unprotected. Moreover, such businesses are unlikely to be regarded by the FCA as part of its consumer protection mission. The resulting regulatory underlap is a matter of

[12] consumer" means any person who is—

(a) a person to whom goods are or are sought to be supplied (whether by way of sale or otherwise) in the course of a business carried on by the person supplying or seeking to supply them; or
(b)a person for whom services are or are sought to be supplied in the course of a business carried on by the person supplying or seeking to supply them;
and who does not receive or seek to receive the goods or services in the course of a business carried on by him;

considerable concern: it is well known that small and medium-sized enterprises (SMEs) and larger "mid-capitalisation" companies that seek external finance are heavily reliant on banks and other financial services.[13]

As a first step to address this underlap, the Panel proposes that the Enterprise Act definition of consumer be widened to include representatives of non-financial businesses for the purpose of submitting super-complaints about financial services.[14] This is particularly relevant if the consumer credit jurisdiction is transferred to the FCA.

Regulatory Processes and Co-ordination

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

The split of supervision and conduct functions should be supported by strengthened communication and consistency. Achieving this will be a challenge for two bodies with different objectives. There needs to be oversight and regular monitoring to ensure that the duty to co-ordinate results in effective co-ordination. The Panel proposes that some of the necessary scrutiny of co-ordination and communication could be provided both through regular internal audit and also through the Special Supervisory Unit, an independent unit within the current FSA which reviews how supervisors are dealing with relationship managed institutions.

In addition, we propose the following mechanisms to achieve a more even balance between the PRA and FCA:

- Annual reporting by the Treasury Committee on how the FCA and PRA are co-ordinated.
- Bi-annual reports by the FCA to BIS and HMT, comparable to the bi-annual stability reports by the Governor of Bank of England.
- A relationship for the FCA Panels with the PRA and FPC, similar to that in s10&11 of the FSMA to strengthen the governance of both organisations.

The exchange of information from PRA to FCA will be paramount to FCA properly performing its functions. There is some concern that, because of the commitment to financial stability, prudential supervision will lose its focus on conduct issues and unfairness and that even if information is passed on to FCA, it will not be adequate. Incentive structures embedded in pay and performance reviews, are required to ensure the sharing of information.[15]

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[13] " .. SMEs that do seek external finance are almost entirely reliant on banks, in the form of bank loans, overdrafts or other working capital products such as invoice discounting and factoring. …Mid-sized firms .. defined .. as having a turnover of £25 million to £500 million … tend to be largely reliant on banks for external finance". "Financing a Private Sector Recovery", Cm 7923, July 2010, HM Treasury and BIS, paragraphs 3.7, 3.11 and 3.12.

[14] This proposal is more encompassing than the proposal aired in "A competition regime for growth: a consultation on options for reform", BIS, March 2011.

[15] The Australian twin peaks model has separate prudential and conduct regulators in addition to the Central Bank who all have representation, along with the Treasury on an overarching Council of Financial Regulators.

In relation to dual regulated firms the process required if the FCA seeks to take action, issue directions, exercise OIVOP powers, or make rules is cumbersome and inhibits the flexibility and responsiveness of the FCA to take immediate action in relation to matters that may result in significant detriment to consumers. We propose that further consideration be given to streamlining the process.

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?

The possibility of a PRA veto could act as a restraint on the FCA properly exercising its consumer protection functions and may therefore result in significant detriment to consumers. Financial firms may use the existence of the veto to game the system, seeking regulatory forbearance on exaggerated grounds of instability risks. We are not convinced that the proposed Parliamentary scrutiny would avert these potential deficiencies.

The PRA is able to intervene where it considers FCA actions are likely to lead to disorderly failure of a firm or firms, or wider financial instability. We accept the need for the PRA to have a veto in the case of disorderly failure, but question whether the PRA should be permitted to exercise its veto on grounds of "wider financial instability", a macro-prudential consideration which should be the FPC to decide.

The Panel proposes that if there is a role for a veto in circumstances where actions proposed by the FCA create a risk of wider financial instability, the decision to deploy the veto should be with the FPC rather than the PRA. The FPC has no direct relationship with the firms involved and, given its broader concerns, the FPC should be more able to balance competing issues. The FPC already has a role in providing advice and expertise to the regulators and in advising on disputes where matters could have material financial stability effects.

Ultimately if the PRA has to use its veto it is a strong indication that it has failed in supervision and the required interventions have not been made earlier. The veto should be seen as a last resort.

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

The responsibility for the authorisation process is not straightforward and lack of clarity may cause problems or inconsistencies. We welcome the separate focus on conduct approval at the authorisation stage as previously there has been an exclusive focus on prudential issues.

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

The new regulatory regime will have a role in promoting competition, efficiency and choice. Barriers to competition and choice, for example through onerous authorisation requirements, market dominance, or monopolistic business models, make it difficult for others to compete except on the same terms and should be ongoing regulatory considerations. These will not be tackled solely through a requirement to consider mutuals in cost benefit analysis but should consider differential regulation according to achievement or otherwise of desired outcomes, particularly consumer outcomes.

The recognition of competition by the PRA should go further and include the proposition in the Coalition Agreement that the regulatory regime includes supporting different ownership models.

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

We are concerned at the possibility of the PRA overruling the decisions of the FCA without sufficient checks and balances and refer to our response to question 18.

<u>Compensation, dispute resolution and financial education</u>

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

The Financial Ombudsman Service (FOS) has played a vital role in the regulatory landscape since its inception. Whilst we are optimistic that consumer detriment and consumer protection will be better dealt with by a focused conduct regulator, one of the valuable functions that the FOS provides is redress to consumers in areas where regulators have been slow to act, for instance in relation to PPI, set off and issues around charges on current accounts. The FOS has recently been under extraordinary pressure as a result and needs to be supported in resources and adequate powers to effectively perform its role.

As has been acknowledged in this consultation, the FOS provides valuable information to identify risks in the system and amongst firms themselves and we support the information exchange with the regulator, a requirement for the FCA to have regard to the information it receives from the FOS, and the obligation to act on the information received where it reveals conduct issues.

The publication of determinations from the FOS provides a vital regulatory tool in order for consumers to exercise choice, regulators to identify risks and problems, and firms to undertake root cause analysis and reduce their costs in problem solving. The publication of complaints data also serves to support these goals and the FOS should be encouraged and enabled to publish more detailed breakdowns of its complaint information and in particular benchmarked data on how individual financial services businesses handle complaints.[16]

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

The proposals for the publication of annual plans and for these bodies to be audited by the National Audit office are useful mechanisms providing that assessments of value for money take into account social outcomes. It needs to be recognised that developing appropriate outcome measures may take some time. The additional mechanisms should not be regarded or used as ways of decreasing the operational independence of these bodies.

European and International issues

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

We support the MOU between Treasury, BoE, PRA and FCA on overall international coordination within the UK's system for financial regulation in the hope that this will ensure issues of consumer protection and conduct risk are appropriately considered as part of the international supervisory process.

[16] As recommended by the report of Lord Hunt of Wirral , "*opening up, reaching out and aiming high – an agenda for accessibility and excellence in the Financial Ombudsman Service", April 2008*

THE FINANCIAL SERVICES PRACTITIONER PANEL

RESPONSE TO HM TREASURY CONSULTATION PAPER
‘A NEW APPROACH TO FINANCIAL REGULATION: BUILDING A STRONGER SYSTEM’ FEBRUARY 2011

14 APRIL 2011

INTRODUCTION

The Financial Services Practitioner Panel has a statutory duty to represent the interests of regulated firms as a whole with the Financial Services Authority (FSA). More details of our role, remit and membership are at Appendix 1. Whilst individual trade associations will provide more detail on specific points on this consultation, the Practitioner Panel's focus in this response is to provide feedback to help to develop a regulatory system which works in the best possible way overall for both regulators and firms: we share a common interest in achieving effective regulation of financial services in the UK. As such, we have answered only the questions in the consultation where we have some specific points to make.

We welcome the progress that has been made since the previous consultation in providing greater detail on how the Government plans to achieve its overall aims. This consultation has a much greater appreciation of practical requirements of a fair regulator from industry's point of view. We are particularly pleased that the name of Financial Conduct Authority has been adopted. The previous name of the Consumer Protection and Markets Authority, which was linked with the role of 'consumer champion', whilst having a helpful reference to markets, promoted an inappropriate role for what should be an impartial regulator. This move, together with the recognition of the need for consumer responsibility in the objectives, has restored balance into the perception and objectives of the conduct regulator.

We are also pleased to see a much greater emphasis on the need for coordination in this consultation: coordination is vital, both in the new UK regulatory system, and in order to ensure effective linkages with international and EU requirements. Although we believe there are still more aspects to be considered, we welcome fact that the importance of coordination clearly recognised in this document.

The main themes where we believe that further work is needed are as follows:

1. **Need for structured mechanisms for engagement with firms throughout the regulatory system**

   Structured engagement with firms is needed at the PRA and across the regulatory system as well as at the FCA. It would be much more effective for the PRA to have a Practitioner Panel which met regularly to engage, rather than a vague commitment at the full discretion of the regulator to consult, as set out in the consultation. Such a Panel would provide a focus for a group of senior executives to have an ongoing commitment to look at the impact of regulatory policy in the UK, and to provide support for PRA negotiations at EU and international level. Such a formal body could publish an annual report, and possibly report to the Treasury Select Committee and so more easily fit with the Government's wish for transparency and public accountability across the system.

   We believe that the proposed Markets Panel will provide a useful and focused forum for debate on the markets and wholesale aspects of the FCA's remit. However, we believe that the Markets Panel should also be given the means to link across to ask questions of the systemic infrastructure regulation which will be transferred to the Bank of England.

We also believe that if the Government is serious in its commitment to regulatory coordination, cost effectiveness and mitigation of the risk of duplication, then it should allow a formal system of feedback from the firms which are at the receiving end of dual regulation. A Practitioner Advisory Panel – consisting of representatives from the PRA and FCA Practitioner Panels, SBPP and Markets Panel could provide feedback and debate across the regulatory system.

2. **Importance of effective coordination between regulators**
We appreciate the commitment to coordination in the consultation, but we remain concerned about how cumbersome the process will be in practice. To help to address this, we recommend that the statutory duty to coordinate should also be enshrined in the regulatory principles, and processes should be shared and streamlined as much as possible. We also believe it will be important to have a forum for firms' feedback on the coordination via the Practitioner Advisory Panel as set out in point 1 above.

3. **Judgement led regulation must be consistent**
We fully support the proposal for regulators to work intelligently and use their judgement. However, the PRA will need to ensure quality and consistency of regulatory approach from different supervisors. There should also be some mechanism of informal and confidential appeal or escalation process for firms within the PRA, as interim step rather than full judicial review. The PRA will be taking decisions which may have a fundamental impact on a firm's business plan – there should be an ability for firms to challenge those decisions without going through a full legal process.

4. **The FCA must highlight different aspects to its remit**
There must be clarity in the legislation and activities of the FCA going forward to ensure a different approach to wholesale and markets regulation compared to retail regulation.

   In addition, although much is made of the FCA as a conduct regulator, it must not be forgotten that the FCA will also take on the prudential regulation for the majority of firms. Ensuring the financial soundness of firms is vital to confidence in financial services. Therefore there must not be a simplistic distinction made between the regulators that the PRA undertakes prudential regulation and the FCA supervises only conduct.

5. **Liabilities in product intervention power for FCA**
The powers of product intervention for the FCA need to be clearly delineated. It could result in some significant potential liabilities. This is an area where many complex products are suitable when only sold to certain categories of people. The problems occur when the selling of the product extends to a wider range of people. We question the responsibilities of regulator towards costs incurred by firms when it bans a product which is subsequently agreed is safe. In the opposite situation, the regulator could become liable for consumer losses if a product is not banned which is subsequently found to have caused problems.

6. **Role and remit of the FPC**
The FPC will have a hugely significant role in the new structure. The macro-prudential instruments that it will be deploying are relatively untested, and yet have

not only economic, but often social consequences – as in the recent debate around levers to be used for the FSA's Mortgage Market Review. The choice of members of the FPC – their experience and balance of interests – is therefore fundamental to the success of this model. The members must also be provided with the resources to enable them to devote time to getting out and about and engaging with a wide range of people and organisations to investigate the possible consequences of their decisions, as well as considering the technicalities of policy options.

7. **Impact of external factors**
Although there is some reference to this in the consultation paper, we would like to emphasise again how important it is to recognise that these changes in the UK system of regulation are taking place on shifting sands of international and EU regulatory systems. The Government must remain alive to the implications of changing regulatory requirements which will also have an impact on firms.

CONSULTATION QUESTIONS

BANK OF ENGLAND AND FPC

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

The Government's decision to establish the detailed macro-prudential toolkit in secondary legislation provides welcome flexibility in being able to adapt the toolkit in response to international and European agreements. This is particularly important as the Panel is concerned about how macro-prudential tools can be effective if applied just to the UK: it will be important for the UK to be able to act in concert with other countries in reducing the impact of any future crises. On the other hand, it will also be important for the FPC to be able to deal with the different points in the economic cycle reached by the UK and other countries.

At this stage it is difficult to tell the likely effectiveness and impact of the instruments described in the consultation paper. Much will depend on the circumstances in which they are used, and the combination of different tools used. We remain concerned that many of the tools which are being discussed are relatively unproven and might have unintended adverse consequences. We also believe that the interaction of macro-prudential and micro-prudential tools will be very important. In this regard, the behaviour of economic agents (individual companies and firms) will need to be taken into account.

We acknowledge the importance of the FPC having a strong and clear mandate in protecting and enhancing the resilience of the financial system, and so contributing to financial stability. However, we agree with the Treasury Select Committee's point that the objective of enhancing financial stability might sometimes involve trade-offs with certain other policy objectives such as economic growth and potentially inflation targets. The additional factors listed of proportionality, openness and international law are reasonable to add. However, we also believe that the social consequences of FPC actions may need to be taken into account.

The recent experience with the FSA's development of the Mortgage Market Review is a case in point. The initial Cost Benefit Analysis (CBA) by the FSA looked purely at the economic criteria for restricting the mortgage market in certain ways. After substantial comments from both industry and consumer representatives, the FSA has acknowledged that a broader CBA needs to be undertaken before taking action in the mortgage market. This is a clear example of where actions taken to control stability in the markets could ultimately affect house prices and so have significant ramifications not only on the economy, but on the broader social agenda. This broader agenda and the transmission mechanisms via individual firms, must at least be considered by the members of the FPC when deciding on the use of different macro-economic tools.

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

We believe that point 4 of the FPC's objective is unnecessarily negative. Instead of: "This does not require or authorise the Committee to exercise its functions in a way that would in its opinion be likely to have a significant adverse effect on the capacity of the

financial sector to contribute to the growth of the UK economy in the medium or long term."
We suggest the objective could be written more positively, such as:
"The Committee should look to exercise its functions in a way that would in its opinion not be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term."
Or even:
"The Committee should look to exercise its functions in a way that would in its opinion help the financial sector to contribute to the growth of the UK economy in the medium or long term."

We continue to be concerned about the balance of membership on the FPC. This is particularly the case with regard to the need for the FPC to understand how their decisions will impact upon the firms which will need to implement the changes. We note that the independent members of the Interim FPC as listed in this consultation, do not have deep and recent experience of running a financial services firm. We urge the Government to ensure that in the permanent FPC and going forward, there should be a direct commitment to deeper commercial financial services experience, such as to specify that at least one member has been an executive director of a financial services firm in the last 5 years.

We believe that is will also be important for FPC members to have current experience of how their measures are being translated into everyday life. There should be a clear responsibility on FPC members to travel the UK and internationally, and to engage with stakeholders, including all types of financial services firms, to ensure that they are alert to the consequences of the decisions that they are taking.

We also question the dominance of membership of the FPC by the Bank and the role of the Governor in chairing the FPC, PRA, Bank and other bodies such as the MPC. Although we appreciate the desire for coordination through this model, we question the potential conflicting objectives and other conflicts of interest inherent in this structure. Not only are we concerned about conflicts, but also the capacity for a single person to hold so many significant roles effectively.

We believe there is also a danger of the chief executive of the FCA being relatively isolated in his focus on the translation of FPC decisions on to FCA-regulated firms. There will be a significant number of firms which will only be regulated by the FCA, and so we suggest there should possibly be another independent member of the FPC who is also at least a member of the FCA Board and has FCA interests at heart.

The checks and balances set out for accountability of the FPC's use of the power of direction are well argued in this consultation, although we remain concerned that the Treasury has the power to 'switch off' or modify the requirements for the regulators to consult or look at costs and benefits in these cases. As we have raised above, the current Interim FPC has relatively little direct industry experience. We would like to be assured that there would be some requirement for the FPC to consider the practicalities of the effectiveness of its measures before implementing any Direction.

The accountabilities around the FPC's power of recommendation have far fewer checks and balances than the direction, and yet may be almost as powerful. Our view is that individual firms, and possibly the PRA and FCA, are, in most cases, unlikely to want to object to the FPC's recommendation other than in exceptional circumstances. This is particularly the case for the PRA, as both the FPC and the PRA are chaired by the Governor of the Bank of England. Therefore the FPC is likely to have almost the power of direction through its recommendation, without the surrounding accountabilities or industry consultation responsibilities.

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

The arguments set out for moving the regulation of systemically important infrastructure to the Bank of England seem to be reasonable. We also support the proposal to await the changes to be required through the European Markets Infrastructure Regulation (EMIR).

Our comment on this question focuses on the fact that the split between the Bank and FCA in the regulation of markets introduces a weakness in the 'twin peaks' system as designed. In addition to the coordination measures proposed in the consultation and our recommendation in respect of Q10 and Q12 below, we advocate that the new FCA Markets Panel should also represent the interests of those firms covered by the systemic infrastructure of the Bank. The Panel should then also be given powers to engage with the Bank in this area, possibly through a similar power as that given to the current FSA Panels in Section 11 of FSMA[1].

PRUDENTIAL REGULATORY AUTHORITY

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

The strategic and operational objectives for the PRA seem to be sound and reflect the aims of the Government in focusing prudential regulation on financial stability. We are pleased to see a recognition within the text of the consultation that much of the detail of prudential regulation will be directed by the European regulatory bodies. It may be worth considering the incorporation of a need to work in collaboration with the European regulatory bodies into the objectives of the PRA.

We welcome the proposal for both regulators to share the same regulatory principles as set out in Box 3.B.

However we recommend that coordination between the regulators is added to those regulatory principles. We appreciate that a statutory duty to coordinate will be introduced, and that high level cross-representation on Boards and other safeguards will be put in place. However, we believe that coordination with the other regulator where relevant should also be enshrined in the regulatory principles. This would provide an ongoing and explicit impetus for coordination at a working level within the PRA and FCA.

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[1] Financial Services and Markets Act 2000 – Section 11 **Duty to consider representations by the Panels**. (1)This section applies to a representation made, in accordance with arrangements made under section 8, by the Practitioner Panel or by the Consumer Panel. (2)The Authority must consider the representation. (3)If the Authority disagrees with a view expressed, or proposal made, in the representation, it must give the Panel a statement in writing of its reasons for disagreeing.

We will be looking for particular emphasis on the second regulatory principle which requires both the regulators to abide by the principle that a burden or restriction imposed should be proportionate to the benefits. We have not always been convinced that the FSA has kept to this principle when it has wanted to apply new regulations. In our last annual report, we highlighted examples of where the FSA has introduced changes where the Cost Benefit Analysis (CBA) has not supported the case for implementation – such as with the publication of complaints data. There have also been initiatives such as Treating Customers Fairly where a CBA was not carried out, even when significant changes were required of firms. We have continued to highlight the need for full assessments of the costs versus benefits in the FSA's development of the Mortgage Market Review and Retail Distribution Review.

In the current proposals, we also welcome the introduction of a clear regulatory principle that consumers should take responsibility for their decisions, and with that, the recognition that the regulator and firms cannot take all the burden of responsibility away from the individual consumer.

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 proposed scope for the PRA seems reasonable in the context of the priorities that the Government has set out.

We would like to emphasise how important it is to develop a regulatory regime which is sensitive to the different character of different parts of the financial services industry. It is something which the Practitioner Panel has highlighted with the FSA on a number of occasions. It is often not appropriate, and can be damaging to 'read across' regulations which have been successful in one part of the industry, into a possibly very different sector of the industry.

We are therefore to a certain extent reassured by the inclusion of this - 'The Government, the Bank of England, and the FSA will continue to consider how the characteristics of insurance firms should be recognised appropriately within the regulatory framework' (3.22). On the other hand, it is somewhat disturbing that the FSA and the Bank of England are seemingly unclear on how to deal with the different requirements of insurance companies.

We recognise that it is reasonable to give the PRA the power to increase the scope of the PRA regulation to designate certain investment firms for prudential regulation by the PRA where it determines they could pose significant risks to the stability of the financial system, or to one or more PRA-regulated entities within their group. We are satisfied that there seem to be significant safeguards around this process.

We also believe that it is right that the FPC should advise the Treasury on any changes to the overall perimeter of regulation, although theirs should not be an exclusive right to advise the Treasury on the perimeter of regulation.

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)?

We are fully supportive of the regulator being judgement led. However, this can only be on the basis of clear and agreed principles which are consistently applied. We welcome the step towards this in the current consultation, with the requirement for the PRA to include short statements of purpose in relation to the rules to allow firms more access to the rationale behind the rules. However, as we said in our previous response, the principles that they are judging against must be clear. The proposal in this consultation for rules to be set out with principles behind is a step in the right direction.

Nevertheless, it will be important to ensure that there are processes in place to allow robust debate on the judgements taken by the regulator, which stop short of formal enforcement or judicial review processes. We would like to suggest an interim review stage, beyond debate with a firm's supervisor, but before the 'nuclear option' of a full public review process.

For the enforcement process at the PRA, we believe that the FSA's current Regulatory Decisions Committee provides an extremely useful forum for debate on the enforcement decisions of the FSA. A similar body should exist to mediate on the debates between the PRA and regulated firms.

We believe that it would be unfair not to allow a full appeal beyond this stage. In our opinion, appeal will be all the more necessary in the case of judgements being taken by the PRA. We would hope that if the interim stages suggested above were introduced, they would lessen the necessity for appeal, but the right of appeal must not be taken away.

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

The overall governance framework proposed appears sound. We are pleased to see that the PRA's status as operationally independent of the Bank of England will be supported by a strong independent Board with a majority of non-executives whose appointment should be approved by HM Treasury. The Board is also due to be bound by principles of good corporate governance.

We do have some degree of concern as expressed earlier in answer to Q3, about the wide range of roles for the Governor – both in terms of conflicts, and also in the capacity for a single person to hold so many significant roles effectively.

We are also unconvinced by the degree of external challenge to the PRA on its budget, value for money and performance against objectives. The consultation document proposes that the PRA will only be accountable to the Court of Directors of the Bank of England for these administrative matters. We would like to suggest that there is some opportunity for wider debate on these subjects. As it stands, the funding will be supplied by the industry and yet there will be no means of the industry getting its voice heard if there are concerns about value for money in the operations of the PRA. We would like to see some opportunity for dialogue with the industry through the practitioner representation as suggested in our answer to Question 10, or at least some wider accountability on the PRA's budget to the Treasury or Treasury Select Committee.

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

The proposed accountability mechanisms for the PRA to Ministers and Parliament, and to the public appear to be sound.

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

The Government and the Bank of England have made it clear that the regulators should only be accountable to Parliament, and not to the industry it regulates. We agree that we do not see the regulators as answerable to the industry in what they seek to achieve. However, engagement with the industry at an early stage of policy development has significant benefits for regulators as well as firms. We believe that this should be incorporated into the set up of the PRA as well as the FCA.

We believe there are significant benefits to establishing a mechanism for structured and ongoing liaison between the PRA and firms. We have developed a detailed paper on the subject, which is at Appendix 2.

We believe a statutory Panel or similar structure would provide:

Structured forum for engagement

- a forum for debate to help the regulator to understand what is required to successfully implement policy proposals whilst avoiding any unreasonably detrimental impact on firms; consideration of costs versus benefits in accordance with regulatory principles; any potential for misinterpretation of judgement-based regulation requirements on both sides; how prudential interacts with conduct requirements from the firms' perspective; and the impact on businesses and consumers more widely;
- early, pre-publication engagement with industry, as Panel members can be signed up to confidentiality requirements, allowing early debate on the pros and cons of new policy developments;
- A forum for practitioners to look ahead to the impact of regulatory developments and initiate its own enquiries of the regulator if it sees a potentially adverse impact or prudential risk. There is no wish to 'capture' regulators through this system – the regulators do not have to follow the advice, but should consider it (the current section 11 power[2]);

[2] Financial Services and Markets Act 2000 – Section 11 **Duty to consider representations by the Panels**. (1)This section applies to a representation made, in accordance with arrangements made under section 8, by the Practitioner Panel or by the Consumer Panel. (2)The Authority must consider the representation. (3)If the Authority disagrees with a view expressed, or proposal made, in the representation, it must give the Panel a statement in writing of its reasons for disagreeing.

Contribution to EU and international negotiations

- Contribution to effective EU and international representation for PRA, with a means of facilitating proactive and early involvement of the industry in EU developments;
- Advice on ensuring that EU rules deliver the desired objectives in as efficient and effective way as possible eg the precise way in which stress tests are conducted, the different options to increase prudential capital or the interactions between the market structure and payment mechanisms and individual firms;

Well informed and quality membership

- High level membership – usually CEO level. If the Panel is statutory, it is given an authority and credibility which enables CEO level people to be persuaded to give up valuable time to become members. Members serve 3-6 years on Panel and so are already up to speed with the regulatory perspective before new ideas are brought to them;
- individual and high level advice to the regulator on specific subjects through regular bilaterals and ad hoc sub groups with Panel chairmen and members outside the formal meeting process;
- Cross sectoral membership provides a focus on effective regulation rather than the sectoral interests of trade associations, which have a separate place in discussions with the regulator;

Transparency and public accountability

- fulfilment of the Government's requirements for transparency and public accountability in the regulators – the Panel can be required to produce an annual report (as the FSA Panels do currently) and possibly report to the Treasury Select Committee on the PRA (and FCA) engagement with firms;
- A possible continuation of the Practitioner Panel's biennial survey of regulated firms which has proved a useful tool for the FSA and provides feedback on how the regulator is performing against its objectives in delivering regulation;

Feedback on coordination between regulators

- commentary and appropriate advice on the coordination of regulatory requirements could be achieved if PRA Panel links to FCA Panels.

The Panel recommends that:

- The PRA has its own Practitioner Panel for consultation and engagement purposes;

  and
- A Practitioner Advisory Panel (with representatives of all Practitioner and Market Panels) is set up to look at overall coordination of regulation between the PRA and FCA.

FINANCIAL CONDUCT AUTHORITY

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

We welcome the proposed name change to the Financial Conduct Authority and its focus on protecting and enhancing the UK financial system. We are pleased to see a more appropriate balance between consumer protection and consumer responsibility in this consultation.

We are concerned about whether the single objective will allow the FCA to uphold the different approaches necessary for regulation in the retail and wholesale market. This is a vital difference, and it must be maintained in the new system.

We would also like to register ongoing concern about whether the regulation of markets will have clarity of purpose within the FCA's current objectives. We welcome the emphasis on a 'proportionate and tailored' approach. However, the regulation of markets requires a broad approach which encompasses stability and systemic risk issues as well as conduct, and it is difficult to see a clear remit for markets regulation within the FCA's objectives.

We support the proposed operational objectives of the FCA, and that the FCA should discharge its general functions in a way which promotes competition.

We are concerned that in the objectives, there is little explicit recognition of the FCA's role in prudential regulation of a large proportion of firms – the consultation paper numbers it at around 18,500 firms. The FCA will need to pursue some proactive and intensive prudential supervision for some of these firms. The Government and the regulators must be careful not to allow there to be a simple categorisation of the FCA as a conduct regulator. There could be a danger of undermining the FCA's work in this area, and its ability to attract quality staff to undertake prudential supervision.

We support the proposed regulatory principles, and the proposal that both the PRA and FCA should have the same regulatory principles. We believe that this will help firms to expect similar treatment from both regulators. In addition, we have already suggested in answer to Q5 that there should be an explicit commitment in the regulatory principles to coordination with the other regulator where relevant.

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

We welcome the proposal for the governance and accountability of the FCA to be based on that which has worked well for the FSA.

We can see benefits to establishing a new Markets Panel for the FCA. This may well go some way to ensuring that the FCA has a clear focus on its responsibilities in regulating the markets and wholesale activities. However, that focus must be developed within the FCA itself, and then can be debated with this Panel. There are few details of the role and remit of the Markets Panel included in the consultation, but we understand that it will have a broad focus on wholesale and markets issues and we support this.

We are also pleased that the proposal to make the Smaller Businesses Practitioner Panel being made into a statutory panel has been broadly supported.

We believe that there will need to be a system to bring together the interests of practitioners across the Panels in debates with the FCA. We also believe that there should be a means for the Panels to engage in debate with the PRA as well as the FCA: dual regulated firms will have fully integrated business plans, and the regulation of conduct cannot be entirely separated from the regulation of the prudential side of a business. Therefore, we suggest that there should be a Practitioner Advisory Panel, or Practitioner Coordination Panel. It should have representatives of all the FCA Panels – together with the PRA Practitioner Panel if one is set up. It should be able to look across the regulatory system and provide the perspective of firms on how coordination is working, and where there are problems. This Panel could also have a role in commenting as part of the annual review of the MOU on coordination between the PRA and FCA.

The requirement on the FCA to produce a report on regulatory failure could provide useful lessons in the future. It may be useful to consider if the Treasury Select Committee could have a specific power to write to the Treasury to trigger a report, in addition to the power of the Treasury itself.

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

We appreciate that the logical conclusion of the regulator having a more proactive role in the prevention of consumer detriment is that the FCA will have a product banning power. However, the powers of product intervention for the FCA need to be clearly delineated, as it could become a double edged sword for the regulator and cause more problems than it solves.

We look forward to discussing the FCA's proposals on the principles of the circumstances under which it will use the product intervention power. We believe that this power will be quite difficult to use and there are potential problems in the responsibilities and liabilities of the regulator in the use of it. We question the responsibilities of regulator towards costs incurred by firms when it bans a product which is subsequently agreed by the FCA to be safe. In the opposite situation, the regulator could become liable for consumer losses if a product is not banned which is subsequently found to have caused problems.

In addition, it must be remembered that there are many complex products which are perfectly suitable when sold to certain restricted categories of people. The problems occur when the selling of the product extends to a wider range of people.

There is also a potential problem with European arbitrage – we question whether the FCA will be able to stop a firm setting up elsewhere in the EU and selling a product in to the UK which has the same characteristics as those subjected to the FCA product banning power.

14. The Government would welcome specific comments on:

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

Although there are benefits in some circumstances to using transparency as a regulatory tool, it must be applied with appropriate safeguards. It must not become the default regulatory tool which is applied in all circumstances.

There will be times when disclosure is not the most effective tool: it could cause immense cost and burden on the firms which have to provide the information and result in so much information being produced that it becomes confusing and is not able to be used effectively by consumers. The information provided can also be misleading in some circumstances. For instance, the Practitioner Panel did not support the FSA's recent moves to publish total complaints data from firms, and did not think the cost benefit analysis supported the FSA's decision. The Panel felt that the information can be misleading: many of the complaints will be from consumers who may want the firm to undertake more than they are able to do under the regulatory requirements – for instance offer a better savings rate, or provide a lower rate loan or larger mortgage.

- **the proposed new power in relation to financial promotions;**

We recognise that this would be a useful and effective power for the regulator. We would ask that the power is accompanied by a direction for the regulator to publish more explanation of why they have asked firms to withdraw a financial promotion. Such information would assist other firms by establishing some financial promotions 'case law' which others could refer to and check their promotions against. This would enable firms to improve their promotions in keeping with the requirements of the FCA, prior to publication, and so protect consumers from the outset.

- **the proposed new power in relation to warning notices.**

We are concerned about any early publication of the details of enforcement action against firms unless there is a clear public interest in the disclosure. Enforcement action against firms is often complex and detailed and any publication of details must have appropriate safeguards. A recent example that illustrates the importance of this is with the recent case of an FSA investigation into the activities of Gartmore fund manager Guillame Rambourg. The revelation of an FSA enforcement investigation had a huge impact, resulting in an outflow of assets and reduction in the share price of Gartmore, such that it was able to be acquired by the rival asset manager Henderson at the end of 2010. In March 2011, and a year after the investigation was made public, the FSA quietly dropped the case.

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.**

We welcome the Government's decision to keep the UK Listing Authority with the regulation of markets in the FCA.

We support the Government's intention to retain the Part XVIII regime pending the European Commission's review of MIFID. However, we are unconvinced that the technical changes as set out in paragraph 4.116 are required. During the recent financial crisis, there were no failings of the regime governed by Part XVIII, and no failure of market infrastructure occurred. In fact, infrastructure providers continued to operate their markets effectively and in an orderly manner, remaining open whilst other parts of the financial sector froze up or failed altogether. As such, infrastructure providers were a key stabilising force.

Therefore, we believe that the technical changes should be set out in detail, so that they can be subject to full consultation. We believe the changes may incur additional costs for the industry, without any justification for the changes having been given.

PROCESSES AND COORDINATION

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

Many of the proposed mechanisms and processes - such as cross membership of boards and MOUs – are essential to have in place. However, there could still be room for operational inflexibility, as statutory duties can often be difficult and cumbersome to apply. Nevertheless, it will be important to put the high level coordination processes in place, with specific statutory recognition of its importance, so that the processes which will fall in beneath can be cross referenced back to the duty to coordinate.

In order to tackle the duty to coordinate at a day to day level, we would like the general duty to coordinate to be also included in the regulatory principles, as we have noted in our answers to Q5 and Q11. This would give concrete effect to the aspiration that firms should not receive conflicting views (p82 4th bullet). A general duty to coordinate and not give firms conflicting views should therefore be added to the regulatory principles, as set out in Box 3.B.

In our previous answer to Question 10, we suggested that, as well as there being a PRA Practitioner Panel, there should be a Practitioner Advisory Panel which is able to look across the regulatory system. It would be made up of the Chairs of the practitioner panels at the FCA and PRA, and another nominated member from each Panel. It would review the coordination processes, and suggested ways in which the regulatory system could be made more effective. A particular role for the Practitioner Advisory Panel would be for it to take a specific role in the annual review of the MOU on coordination between the PRA and FCA.

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?

As there may be times when time critical decisions will be taken, it seems sensible to have the PRA as the lead regulator in this instance.

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

We believe that the proposed new stage in the authorisation process to divide 'conduct' and 'prudential' approval is a sensible response to the new regulatory system.

Of the alternatives proposed in the consultation, we prefer the model which means that firms have only to approach one regulator, and therefore undertake one process in order to gain approval. This should make the process more straightforward for firms, although the decision notice must, as is proposed, set out the reasons why either or both regulators have refused permission. There must also then be a route provided for further discussions – the lead regulator cannot hide behind the fact that they were not the regulator who made the decision without providing any forum for debate on how the firm might be able to change in order to gain authorisation.

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

As in our answer to Q19, we would like to see straightforward and simple processes to enable firms to interact effectively with the regulators. We understand that it is sensible for both the PRA and FCA to have the current FSA powers on variation and removal of permissions, and logical that the PRA has a veto for dual regulated firms. However, we would urge there to be a single gateway for firms to apply to when requesting any variations to permissions.

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

We believe that the proposals seem sensible in allocating powers between the regulators. Again, as in our answers to Q19 and Q20, we would like to see communication and coordination between the regulators on making these decisions. It seems that the best way of achieving this would be to have a single gateway for firms to access either the FCA, or both the FCA and PRA.

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

We fully support the proposal to require the PRA and FCA to conduct an impact assessment in addition to cost benefit analysis when proposing changes to the rules which affect mutually-owned institutions.

However, we question why such an impact assessment should not be carried out for other firms who will be affected by proposed changes in rules.

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

The proposal for the PRA and FCA to each make rules for their areas, with FPC arbitration on financial stability seems sensible. We would only suggest that the FPC would need to make public the result of their arbitration and why they have chosen to take the decisions that they did.

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?**

We support the principles behind these proposals as being appropriate.

We have one comment to make on the proposals to introduce a new power of direction over unregulated parent entities in certain circumstances. There is a concern amongst some firms that other countries are watching the UK's decision in this area. Overseas governments may then look to introduce a similar power in their countries to enable their regulators to extend their powers over firms owned in the UK. The UK Government should be alive to the implications of such quid pro quo actions by other countries.

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

It will be important for the proportionality principle to be maintained in this area. We would like to ensure that there is dialogue with practitioner representatives at a meaningful point in the process to ensure there is consideration of cost effectiveness and efficiency in the setting of budgets and fees.

This is another area where our proposed Practitioner Advisory Committee, as set out in our answer to Q10 could have a role in advising on the cost effectiveness and coordination in the budgets of each regulator, and highlighting any areas of duplication.

COMPENSATION, DISPUTE RESOLUTION AND FINANCIAL EDUCATION

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

We believe that the proposals for the operating model and coordination arrangements for the FSCS seem reasonable.

We would like however, to make the point that the funding requirements for FSCS have the potential to cause systemic risks for certain sectors of the industry which are called on to fund significant levies. In January 2011, investment management firms were unexpectedly required to contribute £236m towards the cost of the FSCS compensating investors who lost money in the collapse of Keydata. This was because the claims went over the limit of contributions allowed from the intermediary sector. The contributions from individual medium and larger investment management firms went into millions of pounds – making a significant impact on those firms' bottom line. The FSA has claimed that it has no responsibility to consider the impact of FSCS levies on the finances of firms.

We believe that the current regulatory changes provide an opportunity for this situation to be changed. The Government should introduce a requirement on the regulator to consider the impact on those sectors affected by any contribution requests for the FSCS which go near to the limits in future.

We would also like to point out that the Keydata-FSCS issue is a good example of how a conduct issue in a single fairly small firm can create potentially significant prudential issues across a wider range of firms crossing the FCA/PRA divide. This illustrates how important coordination between the regulators will be in the new system.

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

We support these proposals as being reasonable.

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

We support the proposals for the accountability of the FSCS and FOS.

We are particularly concerned about the management of costs in relation to CFEB. This is because CFEB has very broad objectives, which make it very difficult to set a tight budget. Given the potentially enormous costs, particularly now that Government half funding has been withdrawn, we believe that CFEB should have a requirement to publish a budget and consult on it with industry.

EUROPEAN AND INTERNATIONAL ISSUES

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

We welcome and support the greater recognition of the importance of coordination with EU and international in this consultation, compared to the last consultation paper.

However, we remain concerned that these changes are taking place during a period of general regulatory change and uncertainty: a new system for financial regulation in Europe is being introduced and international initiatives such as Basel 3 and Solvency II are just being implemented, while other agreements are still being negotiated. Many aspects of the new regulatory system will need to be adapted to fit international agreements as they are developed.

APPENDIX 1

ROLE AND REMIT OF THE PRACTITIONER PANEL

1. The role of the Practitioner Panel is to advise the Financial Services Authority on its policies and practices from the point of view of the regulated community. It has statutory status under the Financial Services and Markets Act 2000 (FSMA). As such, the Practitioner Panel is given access to the FSA's plans for new regulatory policies, and so is able to provide an important sounding board for the FSA before the ideas have been made public.

2. Members of the Practitioner Panel are drawn from the most senior levels of the industry, with the appointment of the Chairman being formally approved by the Treasury, to ensure independence from the FSA. The members are chosen to represent the main sectors of the financial services industry as regulated by the FSA. The Panel currently has senior practitioners from the retail and investment banks, building societies, insurance companies, investment managers, financial services markets, custodians and administrators.

3. The Chairman of the FSA's Smaller Businesses Practitioner Panel (SBPP) sits ex officio on the Practitioner Panel to ensure co-ordination, but debate on issues specifically affecting smaller firms are covered by that Panel. The SBPP is submitting separate evidence to this Inquiry.

4. The names of the members of the Practitioner Panel as at 14th April 2011 are as follows.

Panel Member	*Position*
Iain Cornish *Chairman*	Chief Executive, Yorkshire Building Society
Russell Collins	Head of Deloitte UK Financial Services Practice
Colin Grassie	Chief Executive Officer UK, Deutsche Bank
Mark Hodges	Chief Executive, Aviva UK
Simon Hogan	Managing director, Institutional Equity Division, Morgan Stanley
Garry Jones	Group Executive Vice President & Head of Global Derivatives for NYSE Euronext
Guy Matthews	Chief Executive, Sarasin & Partners [Chairman SBPP]
Helena Morrissey	Chief Executive Officer, Newton Investment Management
Andrew Ross	Chief Executive, Cazenove Capital Management Limited
Malcolm Streatfield	Chief Executive, Lighthouse Group plc
Paul Swann	President & Chief Operating Officer, ICE Clear Europe Ltd
Douglas Webb	Chief Financial Officer, London Stock Exchange Group
Helen Weir	Group Executive Director Retail, Lloyds Banking Group plc

APPENDIX 2

A paper on the Prudential Regulatory Authority's arrangements to consult with the financial services industry as proposed in HM Treasury consultation, February 2011

EXECUTIVE SUMMARY

The Government and the Bank of England have made it clear that the regulators should only be accountable to Parliament, and not to the industry it regulates. We agree that we do not see the regulators as answerable to the industry in what they seek to achieve. However, engagement with the industry at an early stage of policy development has significant benefits for regulators as well as firms. We believe that this should be incorporated into the set up of the PRA as well as the FCA.

Benefits of Structured Engagement
We believe there are significant benefits to establishing a mechanism for structured and ongoing liaison between the PRA and firms. We believe a statutory Panel or similar structure would provide:

Structured forum for engagement

- a forum for debate to help the regulator to understand what is required to successfully implement policy proposals whilst avoiding any unreasonably detrimental impact on firms; consideration of costs versus benefits in accordance with regulatory principles; any potential for misinterpretation of judgement-based regulation requirements on both sides; how prudential interacts with conduct requirements from the firms' perspective; and the impact on businesses and consumers more widely.
- early, pre-publication engagement with industry, as Panel members can be signed up to confidentiality requirements, allowing early debate on the pros and cons of new policy developments
- A forum for practitioners to look ahead to the impact of regulatory developments and initiate its own enquiries of the regulator if it sees a potentially adverse impact or prudential risk. There is no wish to 'capture' regulators through this system – the regulators do not have to follow the advice, but should consider it (the current section 11 power)

Contribution to EU and international negotiations

- Contribution to effective EU and international representation for PRA, with a means of facilitating proactive and early involvement of the industry in EU developments
- Advice on ensuring that EU rules deliver the desired objectives in as efficient and effective way as possible eg the precise way in which stress tests are conducted, the different options to increase prudential capital or the interactions between the market structure and payment mechanisms and individual firms

Well informed and quality membership

- High level membership – usually CEO level. If the Panel is statutory, it is given an authority and credibility which enables CEO level people to be persuaded to

give up valuable time to become members. Members serve 3-6 years on Panel and so are already up to speed with the regulatory perspective before new ideas are brought to them;
- individual and high level advice to the regulator on specific subjects through regular bilaterals and ad hoc sub groups with Panel chairmen and members outside the formal meeting process.
- Cross sectoral membership provides a focus on effective regulation rather than the sectoral interests of trade associations, which have a separate place in discussions with the regulator

Transparency and public accountability
- fulfilment of the Government's requirements for transparency and public accountability in the regulators – the Panel can be required to produce an annual report (as the FSA Panels do currently) and possibly report to the Treasury Select Committee on the PRA (and FCA) engagement with firms.
- A possible continuation of the Practitioner Panel's biennial survey of regulated firms which has proved a useful tool for the FSA and provides feedback on how the regulator is performing against its objectives in delivering regulation

Feedback on coordination between regulators
- commentary and appropriate advice on the coordination of regulatory requirements could be achieved if PRA Panel links to FCA Panels

The Panel recommends that:
- The PRA has its own Practitioner Panel for consultation and engagement purposes; and
- A Practitioner Advisory Panel (with representatives of all Practitioner and Market Panels) is set up to look at overall coordination of regulation between the PRA and FCA.

PRA ENGAGEMENT WITH PRACTITIONERS – DETAILED COMMENTS

1. Introduction
1.1 In February 2011 HM Treasury published a paper: "A new approach to financial regulation, building a stronger system" as a follow up to the original July 2010 financial reform proposal. Responses are due by 14 April 2011.

1.2 This proposed reform deals with setting up the "twin peaks" approach to financial regulation and the Bank of England's role. In this paper we consider only one specific matter, which relates to the way in which the Prudential Regulatory Authority ("PRA") will consult with the financial services industry and, in particular whether there is a potential role for a standing body similar to the Financial Services Practitioner Panel in respect of the PRA.

1.3 The February paper envisages retaining the existing statutory Practitioner Panel and related Consumer Panel arrangements for the proposed Financial Conduct Authority ("FCA") which will also be required to establish a Small Business Practitioner Panel on a statutory basis, and a new panel for Markets Practitioners[3]. In respect of the PRA there is no equivalent proposal in the HMT paper to retain or set up panel-like bodies; instead, the PRA is required to engage with the regulated industry and wider public through various mechanisms, one of which is " *a duty to make and maintain arrangements for consulting industry practitioners"* [4]. This is the question we consider in this response: should a body similar to the Financial Services Practitioner Panel, or a different standing body, help to fulfil the requirement for the PRA to consult with the financial services industry, and potentially engage with more widely, or should the arrangements rely solely on ad hoc industry consultation on specific matters?

1.4 In his recent comments to the Treasury Select Committee ("TSC") the Governor of the Bank of England, stated (as recorded in the preliminary, uncorrected transcript): "At present, before any individual regulatory Act can be made or changed, there has to be a detailed cost-benefit study and often consultation with the industry. Now that makes no sense for a regulator to have to go through all those steps. We should be accountable to you, and if people think the way are conducting regulation is inappropriate, then we should be held accountable by you for not regulating the industry in an appropriate way. But we shouldn't be accountable to the industry itself. That is one of the things that has gone wrong in the past. Our job is to make prudential judgements about the risks on the balance sheet".

1.5. Whilst the post 2007 events in financial markets need to be fully considered in the HMT proposals, the merits or otherwise of industry consultation were also debated extensively in the previous round of reforms. The Financial Services and Markets Act 2000 ("FSMA") required the Financial Services Authority ("FSA") to set up and maintain two bodies: the Practitioner Panel (originally known as the Practitioner Forum)and the Consumer Panel [5]. This was one of the proposals to respond to concerns that the new

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[3] Section 4 of the document covers the FCA and states:" 4*.38 Respondents also welcomed the Government's proposal that the FCA should retain the Practitioner and Consumer Panels, and put the Smaller Businesses Practitioner Panel on a statutory footing. They also suggested a separate markets panel be established. The Government will therefore legislate for Practitioner, Smaller Business Practitioner, Markets and Consumer Panels for the FCA. "*

[4] *Section 3 (PRA) Engagement with practitioners and consumers (points 3.68 to 3.73) states: "3.69 The role of the existing Practitioner Panel is to consider how far the FSA is meeting its statutory objective and balancing its 'have regards' from an industry standpoint, and how far it is giving due regard to the considerations set out in the legislation. It is independent and free to publish its views on the FSA's work. It will be essential for the PRA to engage practitioners if it is to regulate effectively, and to engage with trade bodies and industry representatives where they have appropriate expertise. However, in line with the new 'judgement-based' approach, the Government intends to give the PRA flexibility in deciding what kind of arrangements it wants to establish, but to require that whatever arrangement is put in place is transparent and public. 3.70 The PRA will therefore be under a duty to make and maintain arrangements for consulting practitioners on the extent to which its policies and practices are consistent with its role as prudential regulator, and to make the arrangements public."*

[5] Extracts from the Practitioner Panel web site: "The goal was to create a high-level body, which would represent the views and interests of regulated firms in the regulatory decision-making process, and monitor the regulator's effectiveness. The Financial Services and Markets Act 2000 granted the consolidated financial markets regulator, the Financial Services Authority (FSA), considerable powers. As part of its accountability framework, the FSA was required to set up and maintain two statutory bodies – the Practitioner Panel and the Consumer Panel - to monitor the regulator's activities, ensuring that both buyers and sellers of financial products have a voice in the regulatory process. In 1999 the FSA also set up the Smaller Businesses Practitioner Panel to represent the views and interests of smaller regulated firms. Its Chairman is also an ex officio member of the Practitioner Panel. The Practitioner Panel received statutory status under Section 9 of the Financial Services and Markets Act 2000. On 18 June 2001, the commencement order giving statutory status to both the Practitioner and Consumer Panels under the Act came into force. Section 11 of

integrated regulator, the FSA, had considerable powers in respect of firms and individuals and potentially could use those powers in a manner which was unreasonably detrimental to the industry from a commercial viewpoint, to individual practitioners from an enforcement viewpoint or to the interests of the UK as a whole. It was the perception of a concentration of powers in the FSA which led to the call for statutory panels.

1.6 The Practitioner Panel's key remit under the FSMA and associated regulations has been to represent the interests of practitioners, and to provide input to the FSA from the industry in order to help it in meeting its statutory objectives and its principles of good regulation. Together with the Consumer Panel and the non statutory Smaller Businesses Practitioner Panel, it has therefore played a role in the consultation and regulatory framework of UK financial services regulation. The Practitioner Panel has seen its main role as being that of a 'constructive critic' of the FSA. It has aimed to speak across all sectors of financial services in offering input at a strategic level on important policy issues. The Practitioner Panel has had no directly employed staff, but has been supported by staff on the FSA's Independent Panels Secretariat. Members of the Panel do not charge for their time spent preparing for, and attending, monthly meetings of the Panel and various other ad hoc meetings. The Panel has requested on a few occasions a small budget from the FSA for specific research; ad hoc related expenditure, such as the cost of the Panel's Annual Report and of the Survey of Regulated Firms, is agreed with, and paid for, by the FSA.

1.7 The Practitioner Panel Chairman has met regularly with the Chairman of the Consumer Panel and with the Chairman and Chief Executive of the FSA, through whom he had access to the FSA Board, to discuss issues of particular importance and to raise any emerging concerns. The Practitioner Panel has also submitted a monthly Transmittal Note to the FSA Board, to highlight points raised in the course of its monthly meetings. The Practitioner Panel's Annual Report has been the subject of a formal presentation to the FSA Board. There have been frequent contacts between Practitioner Panel members and Directors and Senior Executives of the FSA. FSA Managing Directors attend Practitioner Panel meetings two or three times a year to provide an update on current issues within their responsibility; and senior FSA executives regularly attend meetings to present on policy developments, seeking the Practitioner Panel's views before going out to wider formal consultation. In addition, from time to time FSA non executive Board members have met with Panel members and also attended full Panel sessions. The Practitioner Panel has estimated that in the past 3 or 4 years it has spent the majority of its time on regulatory matters that span both conduct and prudential areas, with Panel discussions approximately equally split three ways between specific conduct issues (such as treating customers fairly and retail distribution), prudential issues (such as capital, liquidity, recovery and resolution plans),and matters relating to the FSA's overall budget and regulation.

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the Act brought an important part of the formal accountability of the FSA to the Panels into effect. This requires the FSA to consider representations made by the Panel and, where it disagrees with a view expressed or proposal made in a representation, to provide the Practitioner Panel with an explanation in writing of its reasons for disagreeing. The same also applies to the FSA's relationship with the Consumer Panel.

1.8 The Practitioner Panel has taken care to ensure it does not duplicate the important work of the trade associations in representing the views of their members. The associations have the staff and resources to promote the interests of their respective members in response to the impact of FSA policies on the sector they represent. At the same time, the Practitioner Panel has retained close links with the trade associations through regular meetings of Panel representatives with trade body officials, as well as biannual briefings by the Panel Chairman of senior trade association executives, held jointly with the Chairman of the Smaller Businesses Practitioner Panel. In addition, individual Practitioner Panel members often have communications and other links with the trade association representing one sector.

1.8 The Practitioner Panel has conducted and published six biennial surveys of regulated firms, the latest in February 2011 when 4,256 firms (43%) of the total surveyed responded. The main focus of this survey is to find out how the industry feels the FSA is performing its role. However, the survey also asks firms to comment on the role of the Practitioner Panel itself. The survey found that before taking part in the survey 45% of regulated firms had heard of the Panel, although 73% of relationship managed (larger) firms knew about the Panel. Of those able to give an opinion, 86% felt that the Panel and the Smaller Business Panel had an important role to play; 84% agreed that the Panels were independent of the FSA and 87% agreed that they helped the FSA to understand industry views; 60% of firms agreed that the Panels were able to influence FSA policies and decisions.

1.9 It is difficult even with hindsight to assess objectively the extent to which the Practitioner Panel's work has made a real difference to the FSA's regulation since it is impossible to make any valid comparison with a hypothetical situation without the existence of Panel and also because the nature of the Panel's dialogue with the FSA has been to engage early and constructively to ensure industry expertise is brought to bear in developing initiatives. However, it is perhaps worth noting some of the specific areas in which the Panel has sought to engage with the regulators in recent years:

- *Effective supervision of firms*: in its early years the Panel communicated to the FSA the importance of focussing on material matters rather than numerous less significant items. Later, the Panel welcomed the FSA's report on its internal review of Northern Rock as a thorough and critical appraisal of its supervisory failings in that case. The Panel has been generally supportive of the FSA's Supervisory Enhancement Programme since 2008 accepting that this increased the cost of regulation, but the Panel's greater concern was to make sure that the programme really delivered more efficient and effective regulation. The Panel pressed the FSA to ensure that it measured the quality of supervision to ensure that the desired regulatory outcomes were achieved. In the past, the Panel has been concerned that the emphasis of regulatory activity has been wrong – notably, the balance between prudential and conduct of business work. The Panel (and the Panel's Survey) have consistently identified the need for greater continuity in supervision staff at firm level.
- *Retail distribution review*: the Panel was supportive of the general aims of the RDR and its ambitions to raise standards in the investment advice sector. However, the Panel believed the impact of the RDR would leave the mass market with more limited access to financial advice, together with the likely increase of costs in producing products and registered considerable concerns about the

transitional arrangements and delivery of the training required by 2012.The Panel believed this would result in a significant reduction in the availability of advice.

- *Treating customers fairly* (TCF): the Panel was supportive of the TCF target outcomes. However, the Panel felt strongly that the TCF programme had become excessively preoccupied with granular detail turning TCF into a series of process oriented tasks rather than focusing on outcomes, which was at odds with the spirit of regulation. The Panel called for a fundamental overhaul and review of TCF and welcomed the FSA's decision in 2008 to conduct some detailed work on assessing the costs, burdens and impact of TCF.
- *International regulation*: the Panel has consistently encouraged the FSA to take a leading role in the development of European and international regulation. Financial services firms and the UK economy as a whole benefit from UK representatives taking an active and positive part in international policy developments, particularly in the wake of the recent global financial crisis. The Panel was concerned at the level of influence which could be exerted both by the FSA and also by the UK as a whole in this vital area but was pleased that the FSA increased its focus and resources in European and international policy development in 2009/10. The Panel expressed its support for the stance taken by the FSA on a number of European regulatory developments, particularly Solvency 2 and hedge fund regulation.
- *Decisions to pursue individual regulatory initiatives and cost benefit analyses* (CBA): the Panel has routinely reviewed with FSA plans for regulatory initiatives across conduct and prudential areas. The Panel has intervened on several occasions to request sight of CBAs and in some cases has suggested changes. For example, the Panel welcomed the decision to reduce the retention period on taping from 3 years to 6 months. The Panel felt strongly that the FSA should have arrived at its decision on the retention period much earlier on in the process, the root cause being a contentious CBA which had significantly underestimated industry costs. More recently, the Panel has raised in discussions questions over the EU Solvency II requirements for insurers. The Panel remained concerned about the prominence, quality, transparency and robustness of CBA within the policy making process and beyond.

2. Potential role for a body such as the Practitioner Panel in respect of the PRA

2.1 In considering how the PRA should consult with the industry in response to the HMT consultation and whether this would be best achieved by arrangements which include a panel-like role, there are different considerations in respect of a)accountability to; and b) consultation and engagement with regulators to industry. Each is considered below but since the responses to both depend on the objectives and governance arrangements of the PRA, it is first necessary to understand the proposed PRA.

The PRA -Background

2.2 According to the consultation paper, the PRA will be an operationally independent subsidiary of the Bank of England and will have a strategic objective focusing on financial stability, with an operational objective that highlights the role of the PRA in promoting the soundness of firms in a way that does not rule out the possibility of firm failure[6]. This

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[6] *In discharging its functions the PRA must, so far as is reasonably possible, act in a way which a. is compatible with its strategic objective and b. advances its operational objective. The PRA's strategic objective is: contributing to the*

objective is similar to that of the Bank of England's Financial Policy Committee ("FPC"). The PRA will be accountable to the Court of Directors ("Court") of the Bank of England for administrative matters, including its budget and remuneration policy, value for money and performance against objectives. Court will also review the PRA's strategy.

2.3 There will continue to be regulatory principles for the operation of the PRA (and the FCA [7]. In addition, the paper stresses that: "the openness and disclosure principle, relating to the availability of relevant information, highlights the importance of openness and disclosure as a regulatory tool. This recognises the importance of the availability of clear and objective information in ensuring ongoing market discipline. This principle is balanced against the fact that it will not always be appropriate for information to be disclosed, for example where disclosure would harm the regulator's achievement of its objectives. Finally, the transparency principle underscores the importance of ensuring that the regulated community and general public are able to understand about regulatory processes and how they operate, for example, procedures dealing with complaints."

2.4 The paper also states that: "The PRA will take a judgement-led supervisory approach to the firms it regulates. While this approach will focus on forward-looking analysis, it will also include an assessment of how the firm would be resolved if it were to fail and the impact this would have on both the financial system as a whole (including other PRA firms) and the possible use of public funds. The PRA will draw on this analysis as part of its proactive approach to identifying weaknesses within firms, supported by intervention to require firms to address these weaknesses, where appropriate. "

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promotion of the stability of the UK financial system. The PRA's operational objective is: promoting the safety and soundness of PRA authorised persons. Promoting the safety and soundness of PRA authorised persons includes seeking, in relation to each PRA authorised person, to minimise any adverse effect that the failure of that person could be expected to have on the UK financial system.

[7] *The regulatory principles applied to the PRA and FCA are:*

i) *the need to use the resources of each regulator in the most efficient and economic way;*

ii)*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;*

iii) *the general principle that consumers should take responsibility for their decisions;*

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

v) *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*

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

2.5 With respect to the PRA Board, "the role of the non-executive directors will be to constructively challenge the executive and help develop proposals on strategy and policy. To ensure that the PRA board can perform a robust challenge function, the Government will legislate to provide that the board will have a non-executive majority. The legislation will also provide that non-executive directors must be independent and free from material conflicts of interest. "

Accountability

2.6 The HMT paper states that: "Transparency and accountability are key elements of the Government's efficiency and reform agenda.... the most immediate line of accountability for the PRA will be to the Court of the Bank of England, which will hold the PRA accountable for budget and remuneration policy, value for money and other matters. ... Parliament, and specifically the TSC, will take the primary role in holding the PRA to account". (In this regard it is worth remembering that in setting up the FSA much emphasis was given at that time to proposed twice yearly appearances at the TSC of the FSA chairman).The Government envisages that in the new system:

- Treasury Ministers will satisfy themselves that the regulatory system as a whole is functioning properly, and will be accountable to Parliament on that basis;
- Parliament will hold the PRA publicly accountable for the achievement of its statutory objective and 'have regards'; and
- The general public, as the ultimate stakeholder in the regulatory system, has a right to information about the operation of the system and the way that the PRA supervises.

2.7 The accountability of any regulator, such as the PRA, requires a consideration of its particular objectives, its organisational structure and its place in the government structure but also the appropriate democratic and representation arrangements, such as appeals against its decisions, disclosures etc, balanced against its independence to ensure regulatory decisions are taken in an objective manner. Accordingly, the best form of accountability is a complex question to answer. There is a strong argument, however, for ensuring that the firms in the financial services industry should have some input to what the PRA does. Aside from the way in which costs of regulation are funded, which will continue to be via levies on industry which ultimately become a cost to consumers, there is also the question about who picks up the bill when there are regulatory failures, either of individual firms, or of a systematic nature, which have been brought to the fore following the 2007 and 2008 instability. The Financial Services Compensation Scheme arrangements have required firms to provide very significant amounts of money to repay consumers.

2.8 The HM Treasury proposal does not envisage any accountability by the PRA directly to practitioners. The implicit concern must be that the regulators are, in some way, "captured", or "unduly influenced" by the industry and that this somehow influences them to such an extent that they do not impose the right regulatory approach. Practitioners argue that under the FSA regime the regulators were not "captured" in this way; regulators were required to consult with industry but made their own decisions under the FSMA. In other words, the FSA was not ultimately accountable to the industry but did have a responsibility to protect consumers and enhance financial stability and market confidence in a way that was proportionate and cost-effective. Again, at the time of the setting up of the FSA this distinction was recognised. Industry commentators at the time noted that the FSA did not have to follow the advice of industry[8]

2.9 However, ultimately the question of accountability is probably more one of democratic and political representation rather than theoretical or practical implementation of strong cost effective regulation and accordingly the Practitioner Panel accepts that in the new structure of regulation accountability is ultimately to Parliament. The question of accountabilityis, however, important not only to the PRA but also the Bank of England given that the PRA is a subsidiary of the Bank. In this regard it is noteworthy that on 3 March 2011 the TSC announced an enquiry into the Bank of England [9]. This enquiry could also consider the specific issue about the PRA's accountability as one aspect of the Bank's accountability. For the purpose of this response, however, accountability is not considered further and we concentrate on consultation and engagement with industry to inform the future prudential regulators.

Engagement and consultation

2.10 If the PRA is not to be accountable as such to the financial services industry, practitioners believe there should be clear and effective arrangements for consultation and these should also include proper engagement with the industry, not least to inform and equip regulators to make better decisions but also over the cost-effectiveness of the solutions proposed. How should ithe PRA therefore best engage or consult with the industry?

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[8] *Money Marketing 4 October 2001, two months before the FSA obtained its powers wrote (http://www.moneymarketing.co.uk/analysis/n2-the-future/66070.article):The consumer and practitioner panels ..."have the power to make statements and recommendations. The FSA has to pay attention but it does not have to heed their advice, which limits the influence of these two bodies."*

[9] On 3 February 2011 the Treasury Committee reported on the Government's proposals for Financial Regulation. It commended the Bank of England's engagement with Parliament over the MPC. The Government's proposals would extend the responsibilities of the Bank to include monitoring financial stability and taking action against threats to that stability. The prudential regulator, the Prudential Regulation Authority, will be a subsidiary of the Bank of England.
The Government's own consultation notes:
"These changes to give the Bank control of macro-prudential regulation and oversight of micro-prudential regulation will mean a much greater and more operational role for the Bank in the financial system. This will have significant implications for the Bank in terms of its staff, resources, governance and transparency."
The Committee is accordingly launching an inquiry into the Bank of England, to give this issue the attention it deserves.
Key questions will be:

* What kind of decisions should made by each body within the Bank?
o Discussion focuses on the MPC and FPC but are there other policy functions within the Bank's remit which deserve attention?

* To whom should the Bank be accountable?
o Are different accountability mechanisms needed for different functions?

* Are the responsibilities of the Court of the Bank of England clear and appropriate?

* Are the members of the Court of the Bank and the arrangements for its members' appointment and dismissal appropriate?

* What resources does the Bank of England need to carry out its functions?

2.11 On consultation, HM Treasury's paper states that: **"**The Government proposes that there should be no significant reductions to the existing requirements to consult set out in the Financial Services and Markets Act. The PRA will be under an obligation to publicly consult when it makes rules except where to do so would be prejudicial to its objectives. The Government's view is that new regulators must be rigorous in their analysis of the impact of regulation on industry. As a judgement-based regulator, the PRA must focus on increasing the quality of regulation rather than its quantity. However, it is clearly unrealistic to expect that the regulator will produce quantitative cost-benefit analyses especially where it is not possible to monetise or quantify costs and benefits in a meaningful way. The existing FSMA framework allows a substantial amount of discretion to be exercised; the Government believes it will be appropriate to clarify how proportionality will be applied in analysis by the regulators as part of the CBA process. The Government will also give further consideration to the question of whether the requirement to consult could be streamlined when implementing EU rules."

2.12 On engagement with practitioners and consumers, the paper states: "Many respondents to the July consultation recommended retaining the Practitioner Panel and Consumer Panel, in order to ensure that the PRA maintains contact with industry and the wider public. The role of the existing Practitioner Panel is to consider how far the FSA is meeting its statutory objective and balancing its 'have regards' from an industry standpoint, and how far it is giving due regard to the considerations set out in the legislation. It is independent and free to publish its views on the FSA's work. It will be essential for the PRA to engage practitioners if it is to regulate effectively and to engage with trade bodies and industry representatives where they have appropriate expertise. However, in line with the new 'judgement-based' approach, the Government intends to give the PRA flexibility in deciding what kind of arrangements it wants to establish, but to require that whatever arrangement is put in place is transparent and public. The PRA will therefore be under a duty to make and maintain arrangements for consulting practitioners on the extent to which its policies and practices are consistent with its role as prudential regulator, and to make the arrangements public. A number of respondents to the July consultation suggested that the PRA should be required to maintain a standing consumer panel, for the purposes of seeking views from consumers about the effectiveness of its regulation. While consumer issues will be integral to the new regulatory structure – particularly with the creation of a dedicated new consumer protection regulator – on reflection the Government does not think that it will be necessary to retain the consumer panel for the PRA."

The international dimension

2.13 The FSA has summarised in its Business Plan 2011/12 how the international regulatory agenda is increasingly shaping the domestic regulatory priorities. The FSA chairman stated: "Ensuring that we achieve good international agreements is very resource intensive, requiring us to engage on many levels in the Financial Stability Board (FSB), the Basel Committee, the International Association of Insurance Supervisors (IAIS), and International Organization of Securities Commissions (IOSCO)."

2.14 However, it in the European Union developments that the most impact will be felt. The FSA chairman stated: "Influencing the European agenda is the reality that these authorities will play an increasing role in setting the rules within which firms have to operate and which the future UK authorities will have to enforce."

2. 15 The FSA Chief Executive stated: "It is also important to recognise the implications of the change in the European Union (EU) regulatory landscape. As of 1 January 2011, the EU created the new European Supervisory Authorities (ESAs). These will be the key policymaking forums in the EU, leaving the FSA and its successor bodies primarily acting in a policy influencing and national supervisory role....These new bodies will fundamentally change the way in which we operate, both as a rule-maker and a supervisor of firms. They will have decision-making powers over national supervisory authorities, something which the Level 3 Committees did not have. They also have the power to submit draft rules for the European Commission to endorse, where they are authorised to by a specific provision in a sectoral directive. The FSA has become the supervisory arm of a European rule-making process, so our role in policy development is primarily that of influencer, not arbitrator. The EU and its new supervisory authorities have an ambitious agenda for regulatory reform in the financial sector. It is vital that the UK has a strong voice in these new authorities and we have been successful in ensuring we do. We have secured senior representation in all three ESAs through appointments to the management boards of ESMA and EIOPA, and the vice-chair of the European Banking Authority (EBA)." Practitioners agree with this assessment and believe that prudential regulation is subject to international policy setting even more than conduct regulation.

How could a standing panel of practitioners help achieve the most appropriate consultation and engagement aims?

2.16 Specific regulatory initiatives would, in the view of practitioners, benefit from consultations with industry in the vast majority of business as usual situations (ie outside financial stability crises) to provide input on important aspects of prudential regulation, especially **adherence to the principles such as proportionality. I**t is accepted that in a crisis time pressures and other factors might make it very difficult or even impossible to consult, as indeed was the case recently when the FSA introduced measures around short selling. What would be the advantages of a standing panel compared with relying solely on ad hoc consultations with individual firms or trade bodies or bringing together sub groups of practitioners whenever specific issues were deemed to justify this? One such overriding advantage of a standing body is that it would significantly facilitate **transparency** in the regulator's dealings with industry, for example via such a body's own annual report and potentially a survey similar the Practitioner Panel's survey. But it could also **improve the consultation and engagement process** in a number of ways without impairing the regulator's ability to fulfill their mandate: these are listed in the following paragraphs.

2.17 The PRA will be required to develop policy initiatives in a variety of prudential areas, some of which are quite complex, which would benefit from practitioner input. Many of these (but not all) will increasingly be derived from international, especially EU, regulatory initiatives. Both in terms of the **UK regulators' input to the international debates** as these regulations are developed and in terms of their subsequent implementation in the UK, these could benefit from the **expertise of experienced industry practitioners to inform and improve PRA policy development**. Practitioners believe that there has been a tendency in some parts of the UK regulatory structure to "gold plate" EU directives and that this must be resisted unless there is a clear and demonstrable benefit over the costs. But there is also a need to ensure that EU rules themselves deliver the desired objectives in as efficient and effective way as possible and this requires a deep understanding of how financial markets work and the relevant transmission mechanisms. Examples might be around the precise way in which stress tests are conducted, the different options to increase prudential capital, practical considerations implementing liquidity requirements, the interactions between market infrastructure and payment mechanisms and individual firms.

2.18 A benefit of a standing body of such practitioners compared with ad hoc consultation is that it allows the regulators to engage **early** in the process of developing policies rather than towards the end of their development which can be helpful in avoiding unnecessary costs devising proposals which are subsequently found not to achieve the objectives, or in designing more effective regulatory responses. The discussions can therefore be **forward looking** both in respect of individual policy initiatives and in broader areas such as emerging risks in the industry, pressures on industry resources and the impact of international trends, which are increasingly important. For example, the need for a proactive and early involvement in EU discussions is of great importance and is an area in which the UK authorities have on occasion been criticised.

2.19 In addition, **confidentiality** requirements can be built in so that potentially sensitive matters can be discussed fairly openly with the standing body members. Panel members could serve for, say, three years and so become **knowledgeable about topical regulatory issues**, enabling efficient and effective discussions. If they are from large organisations, they can also tap into their **resources to provide information and responses** to regulators as they consider proposals, subject, of course, to confidentiality requirements.

2.20 A **survey** of industry views, conducted by an independent body such as a panel, could also provide direct input to the PRA's thinking and enhance transparency.

2.21 The **PRA board could also usefully engage** with a standing body such as a panel to ensure that the impact of the PRA's proposed and existing policies on the industry is understood, especially where these deal with complex issues that affect behaviour and international issues.

2.22 A panel would also be **available to the FPC**, if at any time direct industry practitioner input to its deliberations were felt appropriate, for example on the design of macro prudential tools or their effects.

2.23 A Panel comprised of senior industry figures, often people at Chief Executive level, who are committed to inputting to regulatory developments, is able to provide **"joined up**" thinking on regulation, including the knock on effects of regulation on business areas. The **cross sectoral** perspective of industry's priorities and consultation responses provided by a Panel is almost unique and from an industry viewpoint is incremental to the sector based industry associations.

2.24 In a twin peaks model, with conduct and prudential regulation separated, having a panel like body of practitioners for the PRA would provide a useful check to ensure there is **appropriate communication and coordination with the FCA**. One topical example is the way in which the recent Mortgage market review involving arrears and repossessions impacts conduct and prudential matters.

2.25 **Considering the Government's stated commitment to the accountability and transparency of the new regulatory institutions, to have** a Panel which publishes an annual report provides some **consistency and transparency** to any PRA consultation/engagement with practitioners. The annual report could be published (as now) and/or presented to HM Treasury or the Treasury Select Committee. This suggests that such a panel would need to be established on a statutory basis rather than leaving the judgement on whether to establish a panel solely to the regulators.

2.26 A standing group or quasi permanent body therefore has several advantages over ad hoc consultation determined solely by the regulator: it can consider the **cumulative impacts** and effects of both regulation and supervision in a way that fragmented arrangements cannot; it can **build a better understanding of the PRA's objectives and operating practices and act as a better sounding board** as a result; it **demonstrates in a transparent way** how engagement and consultation with industry is taking place; it facilitates senior management engagement since in a practical sense it should be able to **attract CEO level practitioners** who will believe that their views are taken into account by regulators.

2.27 Accordingly, one option is to require the PRA to establish on a statutory basis a Practitioner Panel with a remit similar to the existing panel for the FSA but focused on prudential matters. The remit could, of course, identify specific matters which are within the scope of the Panel. As in the case of the existing Panel for the FSA, such a panel would not adopt the approach of a lobbying organisation, rather it would attempt to **help the prudential regulator understand** and be informed by:

- What is required to successfully implement the proposed policies covering practical matters such as information requirements, systems and information technology, resource and skill issues.
- The options available to the regulators to achieve their objectives (rather than questioning the objectives themselves).
- How the prudential proposals interact with conduct and other regulatory initiatives.
- The impact on businesses and consumers more widely of regulatory proposals, especially insofar as they have to deal with internationally active firms, commenting on adherence to proportionality or other principles.

2.28 In addition to the three statutory practitioner panels for the FCA (Practitioner, Smaller Business practitioner, Markets), and our recommended PRA Practitional Panel, consideration could be given to establishing an "advisory" body of practitioners on a statutory basis which would meet to consider prudential and financial stability matters relevant to both PRA and FCA, and also the proportionality and cost-effectiveness of the measures adopted. This group could include members drawn from the Practitioner and Markets Panels, for example, or the chairs and one other member of each of the four FCA Panels. This body could discuss a predetermined list of matters concerning overall regulation and would also be able to pick up specific prudential matters which could include some retrospective in nature (eg macro prudential initiatives taken, how well FCA and PRA are coordinating from practitioners viewpoint), but also forward looking ones, for example around proposed international regulations, emerging risks, or costs of regulation. If it were non statutory, there would be no guarantee that it would be established to fulfil this mandate and it might be more difficult to attract the right calibre of member.

3. Conclusions- Policy Options Recommended by Practitioner Panel

3.1 The HMT consultation paper allows the PRA almost complete flexibility as a "judgement led" regulator in deciding how to engage with practitioners. Industry input is recognised as an important aspect of the effectiveness of regulation which will be increasingly determined in international fora. We recommend there should be specific requirements set for the PRA to engage and consult with practitioners as a minimum in primary legislation. Put in an histrorical context some of the debates and arguments in favour of industry representation and engagement at the time opf FSMA are still relevant today as the regulatory infrastructure is reshaped.

3.2 Putting aside the question of accountability of the FPC and PRA, practitioners have expressed the view that there should be effective engagement with and consultation by the PRA with industry. Ideally this would be expanded to cover also aspects of the FPC's work. However, for the purposes of this paper the engagement with FPC is not considered further. Engagement with the PRA would provide proactive and early consideration of matters by experienced practitioners to assist the prudential regulator in its discussions with international authorities and implementing regulation in the UK. Such a body could be focussed on input around proportionality, cost effectiveness, influencing the international agenda, coordination with the FCA and ensuring the views of industry are considered when designing and implementing alternative prudential regulations to achieve given objectives There are also benefits around transparency, efficiency and effectiveness of having a standing body with which the PRA could engage and consult. Practitioners believe that there should be a commitment to effective consultation and engagement and therefore that the legislation would benefit from a requirement for a standing body to be established for the PRA. There are several options, including:

(i)PRA has its own Practitioner Panel ie a requirement for the **PRA to set up a statutory Practitioner Panel** similar to those required under current legislation for the FSA and proposed for the FCA. This would be a separate panel from the FCA Practitioner Panel and arrangements would need to be made to ensure there was good coordination between the Practitioner Panels (including the Smaller Business panel) and indeed with the Consumer Panel and markets Panel. **Practitioners support this option**.

(ii) FCA Panels are also given access to the PRA (and vice versa) ie a requirement for the **PRA to utilise the proposed FCA Practitioner Panel** in a manner similar to that required under current legislation for the FSA so that **it would become the Practitioner Panel for FCA and PRA**. This would not require an additional panel for the PRA but would require the terms of reference for the FCA Practitioner Panel to include certain aspects of the PRA's work, including coordination between the regulators. Whether this would be a workable solution depends on how the Panel is constituted. If it were a panel for FCA and PRA then it would probably be **workable and a fairly straightforward solution**. If it were a panel for FCA with only a few minor additions in respect of PRA, from the PRA's viewpoint this would raise a number of **practical difficulties** compared with option (i).

(iii)Practitioner Advisory Panel is set up to look at overall coordination, PRA regulation (possibly also markets in Bank; FPC issues)This would be a requirement for the **PRA and FCA to set up a statutory standing advisory body**, possibly termed a panel or forum, but **with a different role** from the current panels; this could involve a narrower focus (from a practitioner viewpoint) on how the PRA is coordinating with the FCA to avoid the duplication which can occur in twin peaks, how it is influencing and implementing international regulatory initiatives to ensure that the views of UK industry are being taken into account and to provide a communication vehicle to discuss other regulatory matters. Practitioners argue that this would usefully supplement option (i).

(iv)**No requirement to establish a statutory standing body** for the FSA but a recommendation that the PRA considers establishing a non-statutory advisory body or working with the industry along these lines. This would be a step forward from the consultation paper but essentially **weakens the commitment to effective industry consultation and engagement compared with the existing arrangements and option (i).**.

(v)**No requirement or encouragement for the PRA to set up a statutory standing body**, relying instead on consultation on specific regulatory proposals with firms and other bodies including ad hoc consultation with specific groups of industry practitioners, as required, on particular matters. This is essentially the position in the consultation paper.

3.3 Practitioners would welcome and support consultation and engagement arrangements and wish to provide advice, guidance and input to the PRA. The Panel therefore recommends that:

(i) The PRA has own Practitioner Panel for consultation and engagement purposes; and
(ii) A Practitioner Advisory Panel (with representatives of all Practitioner and Markets Panels) is set up to look at overall coordination of regulation between the PRA and FCA.

Fraud Advisory Panel

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14 April 2011

Financial Regulation Strategy
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Dear Sirs

Response to the HM Treasury consultation paper "A new approach to financial regulation: building a stronger system" (CM 8012)

1. The Fraud Advisory Panel (the 'Panel') is a registered charity and membership organisation which acts as an independent voice and supporter of the counter fraud community in the United Kingdom.

2. Established in 1998, the Panel works to encourage a truly multi-disciplinary perspective on fraud. It has almost 300 corporate and individual members, drawn from the public, private and third sectors and across a variety of professions.

3. The Panel's role is to raise awareness of the immense human, social and economic damage caused by fraud and financial crime and to help individuals and organisations to develop effective strategies to prevent it.

4. We are particularly concerned to note that the latest HM Treasury Consultation Paper on the reform of the UK's system of financial regulation entitled '*a new approach to financial regulation: building a stronger system*' (CM 8012) does not spell out in any detail the Government's commitment to resourcing the enforcement of current laws and regulations directed at tackling financial and economic crime, whether within or outside the regulated sector.

5. While the Fraud Advisory Panel welcomes the Government's stated commitment to seeking to prevent regulated firms from being used to facilitate the commission of fraud, it should be borne in mind that economic or financial fraud is not the sole form of crime that should concern the Government in this context.

6. Professional and organised criminals use firms in the regulated sector to assist in the commission of a variety of serious offences or the disposal of their proceeds. The proceeds of drug and human trafficking and terrorist financing are not infrequently laundered through the financial services sector and it is essential that adequate, if not enhanced, regulatory and police resourcing is maintained to prevent and attack these pernicious and dangerous areas of crime.

7. The reference in the Consultation Paper to the Government's commitment to setting up an Economic Crime Agency, which, we understand is intended to comprise the existing powers of the Serious Fraud Office and the fraud division of the Crown Prosecution Service as well as the Office of Fair Trading and possibly other agencies is to be welcomed, insofar as the present unified structure of the SFO, as an investigatory as well as a prosecution agency is preserved.

8. This commitment however, appears to be inconsistent with the piece published last week in *The Times* and so far as we are aware, not denied, that the Government intends to break up the SFO and split its prosecuting and investigatory arms between the CPS and the police. This would be a wholly unwise and dangerous move, in our view, that would benefit only the criminal and be an enormously retrograde step in the fight against financial crime.

Yours sincerely

Rosalind Wright CB QC
Chairman

14th April 2011

RESPONSE FROM THE SMALLER BUSINESSES PRACTITIONER PANEL OF THE FINANCIAL SERVICES AUTHORITY TO HM TREASURY CONSULTATION A NEW APPROACH TO FINANCIAL REGULATION: BUILDING A STRONGER SYSTEM

INTRODUCTION

This response is from the Smaller Businesses Practitioner Panel, which was set up by the Financial Services Authority in recognition of the need to have a specific Panel to represent the interests of smaller firms to work alongside the Practitioner Panel and Consumer Panel. We are pleased that the Government plans to make our Panel into a statutory panel of the FCA in the new structure. More details of our current role and membership are set out in Appendix 1.

In this submission, we concentrate on the impact of the changes on smaller regulated firms. This response aims to complement the submission of the Practitioner Panel, which will be responding on the issues for regulated firms as a whole, and those of trade associations who will be responding from the perspective of different sectors. We have therefore only responded to questions where we have a point of view to offer from smaller firms.

Fairness and balance

We welcome the steps that have been taken in this consultation paper to establish regulators which will be balanced and fair in their approach to firms and consumers – and the change of name to the Financial Conduct Authority (FCA) is a key indicator of that.

Proportionality and diversity

We also particularly welcome the Government's emphasis on proportionality in this consultation paper. It is crucial for smaller firms that the regulator takes a proportionate approach in its dealings with smaller firms. We would urge that the Government also takes the size of firm into account in its wish to ensure diversity in the financial services industry. Both the Government and the regulators must guard against a situation where the drive towards security puts so great a burden on firms that only the largest firms are able to survive, as the smaller, sometimes more nimble and more attuned to specific consumers needs firms are unable to compete and survive.

Access and coordination
There will be a large number of small firms which will also need to be dual regulated by both the PRA and FCA. The decision to take on whole sectors means that small banks, insurance companies, credit unions and mutuals will all be caught in the net. It is therefore vital that dual regulated smaller firms have as simple system as possible for access and information from the regulators. There needs to be coordination between the regulators at the level of detail so that small firms are not burdened with duplicate requests for information and visits, or requests for similar information but presented in slightly different formats, by the two new regulators.

Engagement with practitioners throughout the regulatory system
We also support the Practitioner Panel's call for there to be some formal structure for engagement with practitioners at the PRA. We believe that a smaller firm representative could usefully be incorporated within such a Panel, and it could play a useful role in providing a forum for debate in making prudential regulation by the PRA as effective as possible for larger and smaller firms alike.

We believe the best approach will be to have a specialist Panel for the PRA, together with a joint advisory body made up of representatives of all the Practitioner Panels, to look across the regulatory structure, and particularly focus on coordination requirements. If it is not possible to have both of these, there should at least be a joint advisory body of the FCA Panels which has the power and responsibility to advise on issues at the PRA as well as the FCA.

CONSULTATION QUESTIONS

BANK OF ENGLAND AND FPC

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

The Government is proposing effective macro prudential tools which should assist the FPC in meeting its objectives, although we have some concern about the ability of any organisation to be able to predict future developments and be able to react in a way which is reasonable and yet makes an impact on avoiding disorderly failures. At the same time, we would urge a flexibility of approach at FPC level: many of the tools seem largely designed with banking regulation in mind, and yet some could have a wider impact across different sectors. Macro-prudential tools which have a potentially wider impact, such as stress testing, must specifically consider the business model in question.

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

We remain concerned about the accountability of the FPC. Although we recognise that the FPC will not have the activities of small firms as its focus, nevertheless, it must not make decisions which will unnecessarily penalise them. Many of the FPC's proposed governance mechanisms are quite rigid and backward looking, and so damage could already have been done to the interests of smaller firms.

One way of ensuring that the impact of FPC actions on all types of firms are considered is by giving members of the FPC have a clear responsibility to devote significant amounts of time to their role (similar to that of the MPC). Part of their role should involve travelling around the UK and engaging with a variety of different types and size of firm, as well as consumers and academic and research organisations. This will help to ensure the FPC's discussions are grounded in the practical realities of life and business in the UK.

We also believe that the FPC's objective should be phrased in a way that is more positive in terms of working to provide an environment to enable growth in the UK economy. We appreciate that the FPC should not have a remit to go out and actively promote competition per se, but at the same time, it has to be more of an impetus than simply not restricting growth.

We note that "the Treasury will be able to 'switch off' or modify the requirements for the regulators to consult or undertake cost benefit analysis when implementing these tools" (2.97). If this is necessary, the use of such powers should be strictly controlled in the legislation.

PRUDENTIAL REGULATORY AUTHORITY

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

We welcome the idea of both regulators sharing the same regulatory principles as set out in Box 3.B. From the point of view of smaller firms, the most important aspect of the objectives and principles for the PRA is to ensure that they are applied in a proportionate manner. The PRA's will need to make its overall risk appetite clear and ensure this fits with its overall objectives.

We therefore particularly welcome the second regulatory principle which requires both the regulators to abide by the principle that a burden or restriction imposed should be proportionate to the benefits. For smaller firms who will be swept into the PRA as well as the FCA, this is particularly important. Small firms in the PRA will represent a minimal risk to financial stability and, as such, should not have to bear a disproportionate level of regulation or costs. However, equally FCA firms need to be assured that there will be the proper measurement of costs and benefits of new regulatory policies for firms going forward. We will be keen to ensure that the FCA's focus on consumers is not allowed to be used as a justification for measures from the FCA which unfairly burden firms and provide little or no benefits to consumers. This has been an area of vigorous dialogue between the Panels and the FSA in the past, and continues to be so with the FSA's current development of the Mortgage Market Review

We also welcome the clear regulatory principle that consumers should take responsibility for their decisions, and with that, the recognition that the regulator and firms cannot take all the burden of responsibility away from the individual consumer.

We are disappointed that the PRA as well as the FCA is not to be given a role in having regard to competition and diversity. The only concession towards diversity is in the Government's proposals with regard to mutuals. However, there are other aspects of diversity in the financial services marketplace which are worthy of consideration – not least being diversity in size of firm. No one would want a situation where the drive towards security puts so great a burden on firms that only the largest firms are able to survive, and the smaller, sometimes more nimble and more attuned to specific consumers needs firms are unable to compete and survive.

It would be useful also to enshrine the principle that the PRA should promote the soundness of firms but in a way that does not rule out the possibility of firm failure whilst maintaining adherence to the strategic objective.

We also believe that the duty to coordinate should be incorporated into the regulatory principles, to ensure that coordination does not just happen at the strategic level, but is embedded into the day to day processes of the regulators.

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?**

We remain concerned about the burden which may be placed on smaller firms which are being swept into dual regulation by the PRA and FCA. A particular example of this is with credit unions. Credit unions are considered to be high risk but low impact, and so hardly likely to cause a ripple on the financial stability playing field. They are at the simplest and lowest end of the small business ladder, although both the numbers covered and the role played by credit unions are developing. This is recognised by Government which has just granted £73 million to assist credit unions to grow their capital base and stability in the more challenged areas of our society. Over 50% of CUs have no staff and are entirely volunteer run, often with community minded directors with little or no business experience. This has to impact on how regulation and authorisation are viewed.

We welcome the recognition that banks and insurers have different business models and levels of risk, and that insurers have less exposure to causing systemic problems. However, it is of some concern that after a number of years of regulatory activity there is a comment that 'The Government, the Bank of England, and the FSA will continue to consider how the characteristics of insurance firms should be recognised appropriately within the regulatory framework' (3.22).

Within the insurance sector, there needs to be a level playing field for regulation. It is essential that Lloyd's activities are subject to the same degree of regulation as other insurers.

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)?**

We continue to support the idea of regulators applying their judgement in assessing firms, but only on the basis of clear and agreed principles. We recognise that the mechanisms proposed in this consultation go some way to setting out those principles. However, we remain concerned about the regulator not being clear enough in its requirements leading to possible misinterpretation – particularly for smaller firms who would not have such a close relationship with supervisors at the PRA.

1. **Rule-making** – A criticism of the FSA has been that principles and rules are developed, but when clarification and assistance is sought the response has been that it is up to the firm to interpret and work within the principle/rule. The statements of purpose must communicate the reasoning behind the rules and should not be so brief that firms have difficulty understanding the desired outcome
2. **Authorisation** – It looks sensible to allow the PRA to consider the overall picture of a firm, and we would hope that this would be taken in consultation with the FCA. We believe there should be an opportunity for full and open

discussion with the firm over any PRA concerns, so the firm is given the opportunity to modify the model with limitations being imposed only after completion of a formal dialogue between firm and PRA. We continue to advocate a single portal for engagement with the PRA and FCA, at least for smaller firms who are dual regulated.

3. **Approved persons** – Many small firms find it hard to engage first time around with the authorised person regime in the FSA and this may become even more complicated when such approval is spread across the PRA and FCA – so for instance, CEO approved by PRA and MLRO approved by FCA. We would again advocate a single point of entry, at least for smaller firms. In addition, the PRA may need to recognise that firms such as smaller mutuals include individuals on their Boards who do not have qualifications or experience in financial services. They do bring customer focus and give confidence to customers and other stakeholders. We would urge the PRA's judgement to allow these persons to be approved as Board members, while also being expected to participate in training designed to enhance their skills so that they can challenge the executive directors effectively.
4. **Enforcement** – The process surrounding judgment based decisions needs to be strengthened by being able to be subjected to the rigours of a full merits review to consider the decision made. The more restrictive judicial review, simply looking at process, is probably not suitable for a judgements based decision system.

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

The overall governance framework proposed appears sound. However, we would like to be assured that the interests of the broadest range of firms being regulated by the PRA would be able to be taken into account, and this would include smaller firms.

We are also concerned that the accountability of the PRA for its budget and value for money is only to the Court of the Bank of England, when it is the firms that are providing the funding. With the current absence of any formal structure for PRA engagement with the industry, there would be no route for any wider challenge function beyond the non-executive members of the PRA Board. We would like to see a role for any Practitioner Panel engagement with the PRA (see answer to question 10). The new regime should not be significantly more expensive than the FSA for small firms (which did not cause the recent problems). This is particularly the case with small mutual firms which are not posing a significant risk that merits more regulation, and where the burden of regulatory costs is borne directly by the consumer in the absence of shareholders.

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

The proposed accountability to Parliament and Ministers seems reasonable. It should provide some external accountability for the efficiency and effectiveness of the PRA.

However, we still maintain that, as the costs of the PRA are being met by financial services companies, the PRA should have some responsibility to engage in dialogue with representatives of those firms on the way that it spends their money to ensure that there is cost effective regulation. This is particularly relevant as PRA firms will be required to pay a double set of regulatory fees, and yet there seem only to be proposals for dialogue and consultation on the FCA's fees. For smaller firms, any increase in regulatory costs can be significant, and we believe there should be some means for dialogue on those funding to be able to discuss value for money aspects of the PRA budget.

We support the proposals for external scrutiny of complaints.

We note that the proposal is for the PRA to have flexibility to establish appropriate decision-making structures for significant regulatory decisions on specific firms. We believe that the FSA's Regulatory Decisions Committee has provided an important arms length decision making mechanism for the FSA's enforcement decisions. We therefore advocate an RDC style body being required to be set up for PRA significant decisions.

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

We believe that these proposals weaken the existing structure by not recommending the continuance of practitioner panels to consider how the PRA meets its statutory objective and to help it to adhere to the regulatory principles. The introduction of a more judgement based focus should increase the need for practitioner panel engagement to assist the PRA in their role. The Government requires the PRA to establish transparent and public mechanisms for engagement: this could be readily answered by the continuance of at least one statutory panel for the PRA as well as the FCA.

An annual consultation is simply inadequate for purpose. Timely consultation on changes to rules is vital. They have proved most useful through the FSA, as smaller firms can inadvertently get caught up in new regulations that are designed to tackle issues that have no real bearing on smaller firms. The class of small firms in itself is not homogeneous, and more regular dialogue with practitioner representatives would allow debate, and sectors to be forewarned of changes which will affect it in the future. The Panels provide a useful first step of gauging the reaction of the industry to proposed changes, without going out to full consultation. They can also be used to discuss developments in Europe and internationally, and how best to represent UK interests in negotiations. The Panels can often be used as a quick and efficient means of obtaining the views of industry representatives who are aware of the overall regulatory picture.

We believe the best approach will be to have a specialist Panel for the PRA, together with a joint advisory body made up of representatives of all the Practitioner Panels, to look across the regulatory structure, and particularly focus on coordination requirements. If it is not possible to have both of these, there should at least be a joint advisory body of the FCA Panels which has the power and responsibility to advise on issues at the PRA as well as the FCA.

FINANCIAL CONDUCT AUTHORITY

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

We support the proposed objectives and regulatory principles for the FCA. We are particularly pleased with the clarification (in 4.9) of the role of the FCA in securing appropriate consumer outcomes. It is vital that it is made clear in the legislation that the FCA should be an entirely impartial regulator, from whom consumers and firms can expect fair treatment. We also welcome the focus on proportionality and consumer responsibility as key aspects in developing future regulatory policies for the FCA.

As we have said in the answer to Q5, we also believe that the duty to coordinate should be incorporated into the regulatory principles, to ensure that coordination does not just happen at the strategic level, but is embedded into the day to day processes of the regulators.

We fully support the operational objective of facilitating efficiency and choice in the market for financial services, and welcome the Government's commitment to elaborate on the FCA's objectives to encourage the FCA to exercise its general functions in a manner intended to promote competition. This is particularly important, so that the regulator does not put so many burdens on firms, which would risk creating a situation where only the largest firms can operate profitably.

As the majority of smaller firms will have their prudential regulation undertaken by the FCA, it is also important that there is a clear and explicit recognition of the FCA's role in this area. The FCA must guard against prudential regulation being seen as a minor role at the FCA, with the inherent ramifications for recruitment and retention of qualified staff and management time devoted to this area.

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

We welcome the proposal to have a structure for the governance and accountability of the FCA which is similar to the current structure for the FSA. This is a system which seems to have worked well.

We are pleased that there has been general support for the Smaller Businesses Practitioner Panel being made into a statutory panel. We see this as important recognition of the particular needs of smaller firms in dealing with regulatory requirements.

We also appreciate the motivation for the creation of a separate Markets Panel for the FCA. However, we also believe that the SBPP benefits in having its Chairman as a member and taking part in the broader debates of the Practitioner Panel. In the future structure, we believe there will need to be a system to bring together the interests of practitioners across the Panels in debates with the FCA. We also believe that there should be a means for the Panels to engage in debate with the PRA as well as the FCA: dual regulated firms will have fully integrated business plans, and the regulation of conduct cannot be entirely separated from the regulation of the prudential side of a business.

The requirement on the FCA to produce a report on regulatory failure could provide useful lessons in the future. It may be useful to consider if the Treasury Select Committee could have a specific power to write to the Treasury to trigger a report, in addition to the power of the Treasury itself.

We would like to highlight how important the FCA's future role will be in the prudential regulation of the vast majority of smaller firms. We are pleased to see some recognition of this role in Box 4.E, although the detail is due to be provided later this year with the FSA's publication of the FCA's operating model. The quality of this prudential supervision at the FCA could have a significant impact on consumers if not carried out to high standards. It will be vital to be able to attract high quality staff to undertake prudential supervision at the FCA, and so we will be looking to see that appropriate recognition is given to this role for the FCA.

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

We understand the Government's wish for the FCA to have a more proactive and interventionist approach. However, the key will be to ensure that the safeguards are in place, for firms and the regulator, as well as for consumers.

It is good that the paper confirms the government will not expect a "zero risk" regime and are not looking to "pre-approve" products. However the FCA may face some significant responsibilities in taking on such a product intervention power. If the regulator bans a product which is subsequently agreed is safe, it will need to be protected from liabilities for the costs incurred by firms in withdrawing that product. In the opposite situation, there could be problems for the FCA if a product is not banned which is subsequently found to have been a problem – could consumers hold the regulator responsible for losses incurred?

14. The Government would welcome specific comments on:

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

We are not against the FCA using transparency and disclosure as a regulatory tool, as long as appropriate safeguards are in place. The individual reputation of a small firm can be critical to its success or failure. Therefore it is vital that the regulator does not release incorrect details or unsubstantiated claims about firms without having a firm basis on which to do so. The regulator also must not rely on disclosure as the first choice of regulatory tool, as it often will be expensive for firms, and may not provide the sort of information which will help consumers to make informed decisions.

- **the proposed new power in relation to financial promotions; and**

We have no objections to this and support this proposal. Indeed, we believe that more information about financial promotion decisions could help other firms to improve their compliance with financial promotion requirements. Therefore, we would ask that there is a requirement on the FCA to publish the details of these decisions, to build up a library of 'case law' to help other firms to adhere to the regulatory requirements.

- **the proposed new power in relation to warning notices.**

Whilst we understand why the Government is proposing this mechanism, we believe that further work should be done in terms of timing. We believe it is generally inappropriate to publish details of an alleged wrongdoing, although there may be some circumstances where it is appropriate if the investigation into allegations is likely to take a long period of time.

A smaller firm's reputation is a key part of its ability to do business and consideration should be given to safeguards and formalised "triggers" for earlier publication. Otherwise a firm's reputation could be irreparably damaged, even if subsequently they are found to be entirely innocent, as there is a tendency for people to remember even if someone was only accused of an offence.

PROCESSES AND COORDINATION

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

Many of the proposed mechanisms and processes - such as cross membership of boards and MOUs – are essential to have in place. However, there could still be room for operational inflexibility, as statutory duties can often be difficult and cumbersome to apply. Nevertheless, it will be important to put the high level coordination processes in place, with specific statutory recognition of its importance, so that the processes which will fall in beneath can be cross referenced back to the duty to coordinate.

We would suggest that the consultation's proposal of a general duty to coordinate is strengthened. The paper recognises that firms should not receive conflicting views (p82 4th bullet). We would like to see the general duty to coordinate and not give firms conflicting views added to the regulatory principles, as set out in Box 3.B.

The system must be made to work efficiently, particularly for small firms who will be dual regulated. We believe that the regulators should provide a single point of contact or gateway, at least for smaller firms, for as many processes as possible.

We also support the Financial Services Practitioner Panel's proposal to set up a Practitioner Panel Advisory Committee to provide feedback and guidance on coordination between the regulators from the point of view of firms. This would have representatives from all the Practitioner Panels at the FCA – as well as the Practitioner Panel for the PRA if one is set up. Such an Advisory Panel should have the power to look across the regulatory system and comment on all aspects which impact on firms.

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?

As there may be times when time critical decisions will be taken, it seems sensible to have the PRA as the lead regulator in this instance. This is unlikely to take place with reference to smaller firms, unless action against a group of smaller firms working in the same sector may cause financial instability. In this case it seems sensible for the PRA to become involved.

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

From the smaller firm perspective, this is an example of where we continue to prefer that one authority takes the lead role. We think that this may also be more effective for the supervisors dealing with smaller firms that are dual regulated too. We believe that the FCA appears to be best placed to take on this gateway role. However, small firms may also need to be given detailed guidance on prudential requirements from the PRA, so we would not want to see this provision as then causing a barrier for smaller dual regulated firms to access supervisory advice.

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

It seems logical that the PRA has a veto for dual regulated firms, but again as in our answer to Q19, we would like a single gateway at least for smaller firms.

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

We believe that the effective authorising of fit and proper individuals as individuals who have significant influence over an authorised firm is critical to regulation. However, we believe that for dual regulated firms, the proposal that each regulator will share responsibility for controlled functions whilst being in line with their objectives should be reviewed.

In a smaller company where due to scale of the operation, more than one controlled functions may be held by one individual there is an additional complication that means that the individual may have to apply to both regulators for approval for different responsibilities. At present, no specific charges are made for authorising individuals but a change in that policy by either one or both new regulators would lead to additional costs for the firm.

From a smaller business perspective it would be much more satisfactory to make a single application to one regulator and develop a process for each regulator to conduct its checks as necessary and handle the individual's application together. This enables regulators who have differing views on an individual to liaise and come up with a joint decision avoiding the situation where one regulator may accept and the other decline. It should also lead to cost savings for both regulator and firms well as a more co-ordinated approach.

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

We are very supportive of these proposals, as those in the mutual sector have been asking for such treatment for some time.

We believe that the proposal to require the PRA and FCA to conduct an impact assessment in addition to cost benefit analysis when proposing changes to the rules which affect mutually-owned institutions will be a useful discipline. However, we question why such an impact assessment should not be carried out for other firms who will be affected by proposed changes in rules, and this could particularly be applied to the impact on smaller firms.

On the registrar of mutual societies, we believe it is sensible for mutuals in the financial services sector to be registered with the prudential regulator to provide the simplest possible system. It would be yet another hurdle if mutuals were registered elsewhere. For mutuals which do not do financial services business, it seems that registry elsewhere may be sensible.

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

Effective coordination between the regulators will be critical to the process of rule-making for dual regulated firms. In the current system with the FSA, the practitioner panels perform a useful role in giving opinions and guidance on the impact of rules prior to public consultation. We believe that such a dialogue with both the PRA and FCA in the future would be even more important, as there may not be full appreciation of the wider potential impact of new rules on a aspects of a business model of a firm within the other regulator's jurisdiction. If the PRA as well as the FCA had access to practitioner panels prior to consultation, some difficult public debates may be avoided.

The wider consultation process which both the PRA and FCA will be obliged to undergo for new rules should provide some opportunity for public debate around overlap of functions. However, the consultation only suggests the FPC taking a role if disagreements relate to the authorities' assessment of the impact of a rule on financial stability. It seems unclear how differences will be resolved if rules impact on other areas of firms' ability to do business.

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**

The proposals for effective group supervision seem to be appropriate, but consideration must be taken of the size of the group, and proportionality considered for regulatory purposes. Our assumption is that these proposals relate to larger companies, but an unintended consequence could be that smaller businesses get rolled into a more complex supervisory process which is not warranted by the risks presented by the business.

We would like the legislation to be clear that the new power of direction and group supervision will only be undertaken on a proportionate basis, where group companies are large enough to pose significant risk, or are defined as such by associated legislation.

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

It seems sensible for the supervisor to have powers over non regulated parent, within the framework as set out in the consultation.

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?

The proposals for the new authorities' coordination requirements in this area seem sensible. Particularly speaking from the point of view of smaller firms, the costs from such transactions can be significant. High fees must be paid to lawyers and actuaries, which in a mutual company context does impact on returns for members. Therefore, we would ask for a recognition in the legislation of the regulators acting in a cost effective way.

For instance, in paragraph 5.85 the power for both regulators to be able to apply for an independent actuary's report should be limited by a requirement to agree to appoint one actuary for the purpose. The necessity for regulators to use the same actuarial advisor is likely to have positive impact of policy proceeds in the not uncommon situation where a small company is involved.

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

We welcome the recognition in the consultation document that the allocation of fees will be particularly important for dual regulated smaller firms who will have to pay two sets of fees. However, there is still a lack of clarity on how this will be achieved.

We support the requirement for proportionality in the fee setting. This is another area where we are concerned that it there is no current proposal for the PRA to have a system of pre-consultation with Panels in the way in which the FSA currently does and it is proposed for the FCA. There must be dialogue with both authorities to ensure balance in the procedures for fee setting. This is another argument for the proposal for a PRA Practitioner Panel and an overall Practitioner Advisory Panel as suggested in the answers to Q10 and Q17.

COMPENSATION, DISPUTE RESOLUTION AND FINANCIAL EDUCATION

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

We support the proposal for the FCA and PRA to have joint oversight and associated functions in relation to the FSCS. However, we believe that the regulators should take more of a proactive interest in the implications of FSCS funding requirements on regulated firms.

The effects of the recent financial crisis has led to the FSCS requiring far greater funding of defaults than has ever been the case in the past. Small firms in particular find it extremely difficult to plan a virtually unlimited and unquantifiable potential liability to the FSCS with limited financial resources.

It should be noted that the recent request for a huge additional FSCS levy on fund managers to supplement the contributions from intermediaries on the Keydata losses, was unexpected in its size and levied with little notice. Further unexpected requirements of this size could cause instability in hitherto well-run and compliant firms

Neither the FSA nor FSCS are required to take any account of these points or acknowledge that smaller firms are being required unfairly to pay compensation for entirely unrelated matters. It is particularly the case with smaller firms that they are able to build direct relationships with their clients and have less need to pay compensation for other firms to encourage this view. There is also, of course, no appeal against the size of FSCS levies for firms.

We would therefore like a responsibility to consider the impact of FSCS levies on the activities of firms to be added to the PRA and FCA requirements in this area.

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

We support the proposal for the FCA to take on the FSA's existing functions in relation to the Financial Ombudsman Service. We also support the provision to allow the Ombudsman Service to publish determinations if it considers it appropriate to do so. It can be useful for firms, as well as consumers to be able to see how the Ombudsman has made decisions in difficult cases.

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

We welcome the proposals for strengthened accountability for the FSCS, FOS and CFEB.

We are particularly concerned that CFEB has the potential to cause a significant burden on firms since the Government has withdrawn its funding. We support the proposal for there to be NAO auditing of CFEB. In paragraph 6.27 of the consultation, there is reference to CFEB's requirements to publish its annual plan and report under the Financial Services Act 2010. We ask that CFEB's duty to consult the FSA Panels is extended to all the new statutory panels so that the SBPP is also incorporated. It will be important for the SBPP to have a role in assessing the burden of future funding of CFEB on smaller firms in particular.

EUROPEAN AND INTERNATIONAL ISSUES

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

We welcome the greater recognition of the impact of European and international issues in this consultation paper, compared to the last consultation. It is vital that the UK is able to engage effectively in regulatory debates at European and international levels.

We believe there will be some significant disadvantages in the fact that the EU's structure for financial regulation is organised around activities and does not map exactly onto the UK's regulatory structure. MoUs can be inflexible mechanisms to coordinate the UK position relative to Europe across the regulators and Government. However, we are pleased to see plans for a definite commitment to coordination across the regulators for this vital area of international and EU engagement.

We also believe that there should be practitioner involvement in discussions on both conduct and prudential requirements being developed in the EU and internationally. This is another argument for the setting up of a practitioner panel for the PRA as well as for the FCA, as suggested in our answer to Q10.

APPENDIX – COSTS AND BENEFITS

Do you have any comments on the assumptions made for ongoing compliance costs for regulated firms?

We believe that it is unfortunate that the comparison in the appendix is on the cost difference in breaking the regulator into three parts rather than two parts. There will be significant increased costs for smaller firms which are dual regulated. The costs of regulation are difficult to extract, but we have taken the example of a small bank to indicate that the costs are not insignificant.

In this case the small bank spends circa £150k on regulation activities pa which is around 2% of the cost base. On top of this, there have been additional regulatory requirements in recent times – producing an ICAAP, an ILAA, Reverse stress tests and dealing with Single Company view (FSCS) requirements. This broadly might cost an extra £50k in each of the last 3 years. The bank is assuming that when they become dual regulated the annual costs might increase by 40%-50% pa, so £60k-75kpa.

For smaller non banks but dual regulated firms then cost allocation becomes more important – presently the larger firms pick up a larger proportion of the supervisors' costs. Much will depend on how the regulators manage their reviews of the smaller, dual regulated entities – if they duplicate and do not coordinate in their searches for information, then the burden will be considerably higher for small firms.

APPENDIX 1

ROLE AND REMIT OF THE SMALLER BUSINESSES PRACTITIONER PANEL

1. The Smaller Businesses Practitioner Panel (SBPP) was set up by the Financial Services Authority (FSA) to represent the views and interests of smaller regulated firms and to provide advice to the FSA on its policies and strategic development of financial services regulation.

2. Our members are drawn from smaller firms operating across the main sectors of regulated business.

3. We consider several factors when deciding on the definition of “smaller” businesses and take a flexible approach to the application of criteria. A firm may have – in relative terms – a minor market share or small number of employees in the context of its industry sector. In addition, the firm’s financial position and whether the firm is owner-managed may be relevant.

4. We work to ensure that the interests of smaller financial services firms are taken into account and their importance to a healthy, successful and vibrant marketplace are properly reflected in the policies of the FSA.

5. The names of the members of the SBPP as at 14 April 2011 are as follows.

Panel Member	*Position*
Guy Matthews *Chairman*	Chief Executive, Sarasin Investment Funds
Clinton Askew	Director, Citywide Financial Partners
Ian Dickinson	Director, The Brunsdon Group
Paul Etheridge	Chairman, The Prestwood Group
Peter Evans	Chief Executive, Police Credit Union
Sally Laker	Managing Director, Mortgage Intelligence
Fiona McBain	Chief Executive, Scottish Friendly Assurance
Andy Smith	Risk, Governance and Compliance Director TD Wealth International
Ian Templeton	Managing Director, UIA (Insurance) Ltd
Andrew Turberville Smith	Chief Operating Officer and Finance Director, Weatherbys Bank Ltd

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

11 April 2011

Dear Sirs,

A New Approach to Financial Regulation – Building a Stronger System

The Funeral Planning Authority ("FPA") responded to the previous consultation paper "A new approach to financial regulation: judgment, focus and stability" in our letter of 15 October 2010. In this response to the current consultation we rest upon what we said in the previous submission in which we made the case for the continuation of the exclusion of funeral plans from direct regulation by the FCA.

We do not think it would be helpful to set out again what we said in the previous submission but we would be happy to discuss the matter and to provide any further information which would be of assistance.

In the circumstances we do not propose to comment in detail in response to questions posed in the current consultation but we are confident that the FPA's Rules and Code of Practice are consistent with the new approach to regulation. They are kept under review and any desirable changes will be made.

By way of summary of the role of the FPA, the Regulated Activities Order excludes from direct regulation funeral plans as defined in the Order. The aim is to protect the monies paid by the planholder for the provision in the future of an agreed funeral - the monies are held in a trust with a majority of independent trustees or in life policy. The FPA's Rules and the Code of Practice mirror the conditions under which plan providers are excluded from direct regulation and compliance is monitored primarily through annual re- registration. Audited accounts and actuarial reviews are furnished to the FPA. The FPA monitors the requirements in the Rules and the Code on conduct of business. There is an independent procedure for the resolution of disputes between clients and plan providers: in 2010 there were 20 complaints against registered plan providers, all resolved without need for referral to the independent procedure.

The RAO has worked well in delivering cost effective protection for consumers, without inhibiting competition. Providers registered with the FPA represent 90-95% of the industry. There is a positive working relationship between the FPA and the FSA.

Yours sincerely,

Stuart Harland
Chief Executive

Funeral Planning Authority Limited, Knellstone House, Udimore, Rye, East Sussex, TN31 6AR
Incorporated in England and Wales No. 4314827 – Registered Office: 50 Broadway, London SW1H 0BL

A new approach to financial regulation: building a stronger system (Cm8012)

A response paper by the Futures and Options Association

APRIL 2011

A NEW APPROACH TO FINANCIAL REGULATION: BUILDING A STRONGER SYSTEM (Cm8012)

1. Introduction

1.1 The FOA is the industry association for more than 160 firms and institutions which engage in derivatives business, particularly in relation to exchange-traded transactions, and whose membership includes banks, brokerage houses and other financial institutions, commodity trade houses, power and energy companies, exchanges and clearing houses, as well as a number of firms and organisations supplying services into the futures and options sector (see Appendix 1).

1.2 The FOA, while still questioning the need to fragment the regulatory knowledge base and "externalise" the Government's twin peaks approach in such a way as to lose the benefits of unified regulation, recognises the need for change and a more efficient and comprehensive approach to regulation. More particularly, the FOA welcomes this Consultation Document ("CD") as a coherent and proportionate programme for implementing the proposed new regulatory infrastructure and the inclusion of many of the observations made in response to the Government's first consultation on the proposed new structure.

1.3 The FOA notes and supports a number of key statements in the Introduction to the CD, which it believes should underpin the new approach to financial services regulation, namely the Government's recognition:

(a) that *"the financial services sector has a vital role to play in the UK economy"* and that it is *"one of the UK's leading employers, exporters and contributors to GDP… transforming savings into productive investment in the economy, and then allowing the efficient management of risk"* (para 1.1 in the CD);

(b) of the importance of *"competition in delivering good outcomes for consumers of financial services"* and *"efficiency and choice – two core characteristics for competitive markets"* (para 1.27 of the CD), but would observe that the ability to innovate and to sustain competitiveness are equally important core characteristics which, in the view of the FOA, should be incorporated as additional operational objectives;

(c) of the *"accountability and transparency of the new regulatory institutions"*, including the importance of *"certainty, long-term focus and a degree of insulation from political influence"* (para 1.29);

(d) that *"there are wholesale and market activities which do not directly form part of the transaction chain of products and services sold to retail customers. The scale and importance of these activities makes it imperative that they are effectively and proportionately regulated in a way which recognises the particular characteristics of participants in these markets"* (para 1.39) and that this will require a *"strong specialist markets regulation function"* (para 1.40);

(e) that engagement in the programme of international European regulatory reform *"will be a vital point of the UK's response to the financial crisis"* (para 1.42) and that *"ensuring the right UK representation in Europe and international forums will be a key part of this"* (para 1.43);

(f) of the *"potentially negative effects of excessive regulation on market efficiency and consumer choice"* (para 4.9) to the point where it will be part of the FCA's role to remove regulatory barriers, where possible, to facilitate greater efficiency and choice, i.e. this is *"clearly an issue of primary importance along the whole financial value chain and for all consumers of financial services"* (para 4.15 in the CD).

The FOA believes that these expressions and aspects of regulatory policy should lie at the heart of the new regulatory approach to financial services and, if given proper effect, should help to ensure that the drive for safer markets will not impair the Government's express objective to maintain *"a competitive, world-leading financial services industry in the UK"* (para 3.16). Getting this balance right is critically important.

1.4 The FOA notes the strong emphasis given by the Government to information-sharing and close co-operation between the FPC, the PRA and the FCA across a whole range of areas identified in the CD. This is a key concern for our members. We encourage the development of appropriately detailed MoUs to facilitate efficient supervision, particularly for firms which are going to be dual-regulated. We are concerned, for example, that the rule-making process outlined has the potential to cause confusion and uncertainty for dual-regulated firms and would urge the Government to develop a single process for Authorisations, Variation of Permissions and Approved Persons. In particular we believe it is important, in the interests of efficient, co-ordinated supervision that all investment firms within the same group should be subject to one prudential rulebook and prudential regulator only.

1.5 We are also concerned that nowhere in the CD does it appear to mention the importance of timeliness in sharing information and agreeing and implementing co-operative actions. Timeliness is a key element to any MoU between any of these organisations. Past experience in this area indicates that there is a propensity for a party to a MoU to resolve its own difficulties and any domestic "fallout" before imparting that information to other regulators, notwithstanding the responsibilities placed upon it in a MoU.

1.6 The FOA notes and strongly supports the Government's assertion in paras 3.66 and 3.67 that one of its key priorities will be *"reducing the burden of regulation, and improving the quality of regulation"* and that policy makers must *"think carefully about the case for regulation; and where intervention is required, to explore in full the opportunity for non-regulatory and self-regulatory approaches before considering regulatory measures"* and that, as it is put in para 3.67, *"The Government's view is that new regulators must be rigorous in their analysis of the impact of regulation on industry"*.

1.7 The FOA supports the Government's general legislative approach of adapting the Financial Services Markets Act 2000 (FSMA), rather than reinventing the legislation (para 5.3 of the CD).

1.8 The FOA welcomes the Government's expectation that the Treasury Select Committee will *"play a key role in scrutinising and holding each institution to account"*.

1.9 The FOA is concerned that the Government has rejected the view of the majority of respondents, including the FOA, that each regulator should be required to pay due regard to the objectives of the other on the basis that this objective would be *"better served by a statutory duty to co-ordinate"* (para 1.47). The FOA does not accept that this is correct. Put simply, the objective of co-ordinating outcomes and responses is not the same as an obligation to pay due regard to the objectives of other (UK) regulatory authorities. More positively, such a "due regard" objective will facilitate co-ordination on a basis that is more likely to be acceptable to each of the authorities if they each know that their statutory objectives are being factored into the process.

1.10 The FOA notes that this consultation period is *"shorter than normal"* (para 1.54) in order to expedite the change process and that this is to be compensated by an exacting process of pre-legislative scrutiny. However, if this is to provide the promised *"significant additional opportunity"* to provide input (para 1.54), it should not be the subject of another unduly abbreviated timescale.

In addition, the FOA notes and welcomes the assurance:

(a) that the FSA and the Bank of England will be publishing "later in the Spring" a further paper setting out, in much more detail, the regulatory philosophy, approach and processes, particularly in operational areas, of each authority (para 5.2 of the CD); and

(b) that there will be further papers prior to the formal start-up of the PRA and FCA, describing how the responsibilities will be divided up between them and how they will work in practice (para 5.28 in the CD).

1.11 While the FOA notes the intention of the Government to put the new regulatory architecture in place by the end of 2012, the FOA shares the view of the Treasury Select Committee that getting the construct right is more important than fulfilling a set timetable. This has become a notable problem with regard to the programmes for regulatory change in both the US and the EU. The FOA would urge the Government to put qualitative and achievable deliverables ahead of complying with physically-set timetables.

2. The Bank of England and Financial Policy Committee

2.1 The FOA anticipates that this section of the CD will be the subject of detailed comment by those trade associations that focus on macro-risk and banking issues and, therefore, has restricted itself to making a number of general observations.

2.2 The FOA notes and supports the Government's objective to place the Bank of England at "the heart of the financial system" (para 2.1 of the CD) and to be responsible for *"all aspects of financial stability"*.

The proposed FPC macro-prudential toolkit is wide-ranging and potentially significant in impact. The tools currently lack detail and some appear to provide for UK gold-plating of EU and international standards which could result in an unlevel playing field. Although we understand why the Government is of the view that a broad toolkit may be necessary, the tools should be explained in detail and framed within a system of checks and balances that provide the market with clarity regarding their use. Equally, as a practical matter, given the international nature of markets, it is not clear to us that deployment of the tools in the UK necessarily will be sufficient to address the identified potential risk.

2.3 Further, the FOA questions the statement in the third indent of para 2.6 in the CD that the *"lack of standardisation in some markets – such as the over-the-counter (OTC) derivatives – can discourage investment in these products"*. In the view of the FOA, lack of standardisation is not the issue, but rather whether or not OTC derivatives are sufficiently transparent to facilitate accurate risk assessment and on-going valuation. Indeed, an unduly zealous approach to standardisation will actively impair the ability of the end-users to manage their non-standardised risks.

2.4 The FOA is in broad agreement with the summary in Box 2.B, but believes that the fourth objective could be more positively phrased, i.e. the words *"this does not require or authorise the Committee to exercise its functions in a way that would, in its opinion, be likely to have a significant adverse effect…"* should be changed to *"the Committee shall not exercise its functions in a way that would, in its opinion, be likely to have a significant adverse effect…"*.

2.5 The FOA supports the observations in the CD:

(a) that *"the FPC will not be responsible for delivering any particular kind of leverage, debt or credit growth"* and that its role will be to try to ensure that *"whatever the level of each indicator might be… it is not a threat to the resilience of the financial system"*;

(b) that the FPC, when exercising its functions, will, where possible, look to avoid impeding the PRA's or FCA's pursuit of their own objectives; and

(c) that it is important to get the balance right between enhancing financial stability and facilitating sustainable economic growth, and that these should be complementary objectives (para 2.16 of the CD).

2.6 However, the oversight responsibilities of the FPC should include an on-going assessment of the economic and social impact of capital ratios through different growth and credit cycles.

2.7 With regard to para 2.20 of the CD, the FOA agrees that some factors are more relevant to the work of a line regulator than for a high-level policy committees such as the FPC, but believes that the FPC should still be required to take into account certain relevant factors such as economic growth and the social impact of its deliberations, bearing in mind the devastating economic and social consequences that could flow from using *"the levers and tools at its disposable"*.

2.8 The FOA notes the intention in para 2.28 of the CD to legislate *"to exclude individual regulated firms from the FPC's powers, including the issuance of any… recommendations to specific individual firms"*. Presumably, this does not apply to recommendations about specific firms to the PRA/FCA. Otherwise, it would:

(a) exclude any private recommendations which, surely, should not be the case;

(b) contradict:

(i) the wide-ranging statement that *"the FPC will have the flexibility to make recommendations about anything it believes relevant for financial stability"*, including, presumably, "anything" carried on by a specific named firm (2.36);

(ii) the observation that the FPC will be able to target *"a very small number of firms that manifest a particular risk"* (para 2.29);

(iii) the statement that *"the FPC's power to recommend needs to be broadly defined to allow it to recommend any action it believes is necessary to protect or enhance financial stability"* (para 2.42); and

(iv) the role of the FPC to provide advice and expertise to the regulators *"on all matters relating to systemic financial stability and risks to overall stability"*, which could flow from one major institution (para 2.14-19)

The issuance of recommendations would still be compatible with the observation that the FPC should not be empowered to make *"a firm-specific intervention or override the PRA or FCA on the supervision of specific individual firms"* (para 2.73). That being said, in instances where a recommendation is made which relates only to a very small number of firms, adequate safeguards should be provided in relation to the exercise of these powers.

2.9 The FOA welcomes the Government's observation that *"macro-prudential measures are likely to prove more effective if the broad framework for their use is designed and adopted at the international level"* (para 2.46 of the CP).

2.10 With regard to para 2.68 of the CD, the FOA recognises that increasing margins / restricting what is eligible collateral can sometimes be used with varying degrees of success to control order flow, but the FOA questions whether this is an appropriate use of collateral / margin insofar as they are mechanisms designed to mitigate risk rather than achieve regulatory policy objectives. The FOA would refer to FSA's own observations in response to the European Commission's initial consultation on the regulation of derivatives, that capital requirements should not be used punitively.

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

2.11 We note that the tools currently lack detail and some appear to provide for UK gold-plating of EU and international standards which would place the UK at a disadvantage competitively. The macro-prudential tools proposed for the FPC raise a number of concerns, in particular, the 'ad hoc tools created for specific circumstances' where the Treasury can create a specific tool for the FPC immediately where it sees fit, with little due process or checks. We are also concerned the proposed tools could lead to increased gold plating of EU and internationally driven rules.

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

2.12 In developing further macro-prudential tools, we suggest that there is engagement with the European Systemic Risk Board and the Financial Stability Board to ensure European and international consistency.

2.13 The FOA supports and welcomes the recognition by the Government that a power of direction is a *"significant intervention"* and that it is important to *"minimise the risk of unintended consequences"*. However, the FOA agrees that the FPC should be prohibited from issuing directions that constitute firm-specific interventions or overriding the PRA's or FCA's supervisory responsibilities, but this is presumed not to apply to recommendations (see further para 2.8 in this response).

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

2.14 The FOA believes that the proposed ratio of five external members to six bank members is approximately right, but nevertheless welcomes the Government's assurance that it will look at the observations of the Treasury Select Committee in this regard more closely.

However, overall, the FOA still questions whether that the potential socio-economic effect of the application of macro prudential tools has been fully appreciated and we ask that the objective, governance and accountability mechanisms should be given further consideration. The proposed tools include allowing the Treasury to create an "*ad hoc* tool", with Parliamentary approval only required 28 days later. By its very nature, the concept of ad-hoc tools is vague and we would like to see adequate safeguards provided in relation to the exercise of these powers.

In particular, as we note above, we believe that the duty to have regard to economic growth should be positive rather than negative i.e. in exercising its regulatory functions, the FPC should be required to have regard to the impact on economic growth and that the international nature of financial markets should be reflected in the FPC's objectives and terms of reference. We would refer the Government to article 3.1 of the ESRB Regulation which sets out its Mission, Objectives and Tasks. The recognition of the importance of the contribution of the financial sector to economic growth is expressed in more positive terms and we would suggest the Government adopts a similar approach.

2.15 As a separate point, we believe further consideration should be given to how disagreements between the FPC and the PRA and/or FCA will be resolved finally, notwithstanding the "comply or explain" process.

Q4. Do you have any comments on the proposals for the regulation of systemically-important infrastructures?

2.16 The FOA acknowledges that recognised clearing houses will become systemically significantly more important as they assume the role of clearing standardised / sufficiently liquid OTC transactions – and that the Bank of England should be well-placed to regulate them. However, bearing in mind their integrated role with the function of execution and the fact that a significant number of clearing houses are structurally integrated within exchanges, close co-operation between the Bank of England and the Markets Division of the FCA will be essential, particularly if the Government is to deliver on its strategic and operational objectives of *"protecting and enhancing the integrity of the UK financial system"* and enabling the FCA to *"contain a strong markets regulation function"* (para 4.10 in the CD).

In this context, the FOA notes in para 2.135 of the CD, that the various bullet-points do not mention "linkages" with other CCPs, which is likely to become an increasing feature of the marketplace in cash equities and, at some point in the future, other asset classes, including derivatives.

Crisis Management

The question of which regulatory authority is responsible for resolving CCPs that fail and the powers that will reside with that authority is not referred to in the CD (nor is it addressed in EMIR). We also note that the CD does not discuss the powers available to the European Supervisory Authorities or how they fit with the UK's regulatory framework for crisis management. We believe it is critically important that UK regulators are obliged to consider the European Supervisory Authorities powers and resolve any potential conflicts before they crystallise.

Should the Bank of England be appointed the UK's Special Resolution Authority for infrastructures, we are concerned that the Bank of England could face conflicts in performing such a role versus its role as direct supervisor of infrastructures. Consequently, we consider that appropriate internal divisions to perform each of these roles would need to be created within the Bank.

Furthermore, as the PRA is to be both: (i) the prudential regulator; and (ii) responsible for triggering the use of special resolution regime powers for banks, we are concerned that the PRA's role in performing these two functions could create additional potential conflict within the Bank of England. We note this consultation expresses the view that the potential for such conflicts to arise is limited, as roles and legal responsibilities are clear and the PRA will be operationally independent from the rest of the Bank of England. However, we remain unconvinced that the risk of conflicts is sufficiently mitigated.

3. Prudential Regulation Authority

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

3.1 With regard to para 3.9, the FOA agrees that the *"efficiency"* and *"proportionality"* principles and the independent auditing responsibilities of the National Audit Office will help to ensure that the regulators pay sufficient regard to the cost-effectiveness and value-for-money of regulation, i.e. that they are observed "on the ground" and in the rules.

3.2 In general terms, the FOA supports the regulatory principles to be applied to both the PRA and FCA as set out in Box 3.B. The FOA would encourage recognition of the impact of economic growth in this regard (similar to the objectives set for the European Banking Authority) and market confidence.

3.3 The FOA continues to be concerned, however, that the key elements in sustaining the global positioning of UK-based financial services, namely, diversity, innovation and competitiveness, do not feature in the regulatory principles of the PRA even as factors just to be taken into account. The FOA believes it is unacceptable that the regulatory authorities should be able to exercise a broad range of interventionist powers, including the banning of products and monitoring firms' business strategies (including imposing limitations and requirements on those models) without having to pay any regard to those factors. It seems entirely logical that the more interventionist the regulator, the more it has to be seen to be balancing its public policy objectives in terms of safety and soundness with the other policy objectives of ensuring that firms and businesses are able to pursue a competitive agenda, which will include offering diversity and innovation. It is difficult to see how this omission can be reconciled with the Government's asserted policy, as it is put in para 3.16, *"to see a competitive, world-leading financial services industry in the UK"*.

3.4 With regard to para 3.19, the FOA would repeat its observation that imposing a general duty on both authorities to co-ordinate and consult each other on their views is not the same as requiring those authorities to pay due regard to each of the objectives that are placed upon them (see para 1.9 in this response).

Q6. What are your views on the scope proposed for the PRA, including Lloyds, and the allocation mechanism and procedural safeguards for firms conducting the "dealing in investments as principle" regulated activity?

3.5 The FOA notes that the PRA will have the discretion to be able to designate any investment firm to be prudentially regulated by it if, in its view, it could pose a significant risk to the stability of the financial system or to a PRA-regulated entity within the group if it has permission to *"deal in investments as principle"*.

The FOA would make the following observations on this power:

(a) The degree of systemic risk posed by an investment firm to the system is likely to be greater where it poses a direct risk to the system, and that should be the core test rather than where the risk is indirect, e.g. by posing a risk to a PRA-regulated entity within the same group.

(b) As the CD rightly observes in para 3.24, there are a very large number of firms that have permission to *"deal in investments as principle"*. Bearing in mind the significant increase in cost that will accrue to being regulated by the PRA (e.g. dual regulation, additional minimum capital requirements, etc.), it is important that the latitude given to the PRA in making this assessment is not unduly wide (and the FOA notes that this will be limited to "BIPRU Euro 730k firms").

(c) The FOA welcomes the fact that the PRA will be required to consult with the FCA in making this determination and that firms will be given an opportunity to make representations and have a right of appeal.

(d) The FOA urges the Government, in the interests of efficient, co-ordinated supervision, that where the PRA designates an investment firm as subject to PRA regulation, all investment firms within the same group should be also subject to PRA regulation and one prudential rulebook.

3.6 The FOA notes that, while the original consultation paper envisaged that some 1800 firms could be PRA-regulated, para 4.45 draws the conclusion that, of the 27,000 firms that will be regulated as to business conduct by the FCA, it will only be the prudential regulator for 18,500 firms (para 4.47), suggesting that some 9000 firms could be the subject of PRA regulation. This is a material increase on the original assessment, even allowing for differences arising as a result of inwardly-passporting firms which will be regulated as to business conduct by the FCA. This is further confused by the assessment made by Hector Sants in his speech on 2nd March that the FCA will have prudential responsibility for approximately *"25,000 of its 27,000 firms; only 2000 will be shared with the PRA"*. The FOA believes that with the passage of so much time since the first consultation paper, this figure should be better clarified at this stage.

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

3.7 The FOA supports the view that the PRA should take a *"judgement-led supervisory approach to the firms it regulates"*, but would emphasise that the criteria by which it reaches judgements about those firms should be transparent, predictable and applied consistently to ensure that same-shape firms are treated in the same way.

3.8 The FOA continues to be a supporter of a principles-based approach, but would again emphasise the importance of transparency, predictability and consistency and that principles should not be used merely as a means of underpinning the enforcement capability of a regulatory authority. They should become, progressively, a mark of a responsible industry sector where reliance can be placed on senior managers. To this end, the FOA welcomes the assurance that key rules will be accompanied by *"short statements of purpose"* to lend clarity around how the principles will be applied and implemented.

3.9 The PRA will establish a Proactive Intervention Framework (PIF) with the aim of increasing the probability of recovery of firms. While the Government intends to provide more details in due course on the PIF, this nevertheless represents a significant new process, particularly when combined with a judgement-led approach. We would highlight at this stage that any approach with 'demarcated stages' regarding pre-resolution could reinforce a downward trajectory for a firm as soon as it becomes clear to the market it has entered a particular stage. Equally, we do not believe that a framework around ex-ante determinations of risk would be sufficiently responsive to the individual circumstances of any given firm. We believe the focus should be on the response to the actual risks as they occur rather than adherence to a prescriptive rulebook.

Q8. What are your views on the proposed governance framework for the PRA and its relationship with the Bank of England?

3.10 With regard to para 3.39, the FOA notes that key PRA decisions involving major firms or other high-risk issues will be taken by an executive committee of the board. The FOA would refer to para 3.46, in which the Government will require the PRA to be bound by principles of good corporate governance and would urge that any such decision-making process should include the input from those non-executive directors on the board who will not be subject to any material conflicts of interest in participating in that decision-making process. The seriousness of decisions of this nature call for some degree of independent expert input, particularly since, as it is envisaged in para 3.49 in the CD, *"PRA board members will take significant roles in critical firm-specific decisions"*.

Q9. What are your views on the accountability mechanisms proposed for the PRA?

3.11 The FOA generally agrees with the provisions regarding accountability set out in paras 3.53-3.63 in the CD.

3.12 Para 3.62 of the CD does not make it clear that the continuing role of the Complaints Commissioner will apply to complaints against the PRA, insofar as the paragraph refers only to the fact that it will have a system for the investigation of complaints and it will be distinct from the procedures applicable to the FCA. The observation that *"external scrutiny"* of complaints will be carried out by a Bank nominee could undermine its perceived independence if the process of appointment is not seen as sufficiently independent.

Q10. What are your views on the Government's proposed mechanisms for the PRA's engagement of industry and the wider public?

3.13 With reference to the assurances given in paras 3.66 and 3.67 in the CD over the rigour with which the regulatory authorities must analyse the impact of regulation on industry, the FOA would emphasise the proven importance and role of the existing Practitioner Panel in relation to FSA policy, rules and processes. The FOA believes that such a statutory panel should be established – although it would have to reflect a very different level of relevant expertise – with regard to the PRA. It is not clear from paras 3.69 and 3.70 of the CD whether or not it is the Government's intention to establish such a Panel. The FOA believes that it should be.

3.14 On the other hand, the FOA shares the view of the Government that there is no need to establish a consumer panel, taking into account the obligation on the PRA to consult with the FCA where any of its decisions will have a material impact on consumers – a process of consultation, which should include, wherever appropriate, consultation with the FCA's own Consumer Panel.

4. Financial Conduct Authority

4.1 The FOA agrees with the opening statement to this section that *"good conduct of business is an essential element of a strong and efficient financial system able to play its vital role in supporting the real economy"*.

4.2 The FOA welcomes the decision to rename the new authority the Financial Conduct Authority (FCA) and its assurances that, in para 4.9, *"the FCA will be an entirely impartial regulator from whom firms and consumers can expect fair treatment"*, *"the potentially negative effects of excessive regulation on market efficiency and consumer choice"* should be avoided and *"the responsibility of consumers for their own choice"* should not be undermined.

4.3 With regard to the regulation of wholesale and markets activities undertaken between professional counterparties, the FOA welcomes the Government's acknowledgement that, although there are links between retail and wholesale market activities, a *"more nuanced regulatory approach will be appropriate"* and, as it is put in para 4.10 in the CD, that wholesale and markets regulation will be sufficiently flexible *"to ensure that the specialist requirements of these markets are appropriately reflected and recognised"*.

4.4 The FOA particularly welcomes the Government's recognition that it will be part of the FCA's role to remove regulatory barriers, where possible, to facilitate greater efficiency and choice and that this is *"clearly an issue of primary importance along the whole financial value chain and for all consumers of financial services"*, particularly in relation to wholesale markets.

4.5 The new intervention powers and enforcement powers envisaged are wide and potentially intrusive and in particular, we have concerns around the proposals to publish warning notices. We are concerned that publication of warning notices threatens causing immediate damage to the reputations of firms and/or individuals before the enforcement decision process has completed. As a consequence, publication of a warning notice could cause irreparable, material damage to a person, even though the proceedings eventually find in their favour. Consequently, we are concerned that the damage that could occur from publishing warning notices outweighs the merits of the proposal. If such powers are to be used we would urge the importance of developing detailed and appropriate safeguards and clarity over the use of the powers.

4.6 With regard to the CD's observations on financial crime in paras 4.32-4.34, the FOA supports the Government's decision that the FCA will have a free-standing duty to take the necessary action to minimise the extent to which regulated business can be used for criminal purposes and to counter financial crime in its role as a conduct regulator. However, the FOA is concerned that the FCA should act fairly and proportionately, i.e.:

(a) while it has a clear responsibility to take forward its policy of *"credible deterrence"*, including exemplary sanctions, those sanctions must, at the same time, be proportionate to the nature and gravity of the offence;

(b) the FCA, in deciding whether or not to bring criminal proceedings, should take into full account such issues as wrongful intent, the gravity of the act or omission, the need to be fair to a defendant and whether the offence involved dishonesty or recklessness, i.e. it should be careful to use its powers of bringing criminal prosecutions in a proportionate manner when considering their use for the promotion of regulatory objectives.

Q11. What are your views on (i) the strategic and operational objectives; and (ii) the regulatory principles proposed for the FCA?

4.7 The FOA supports Box 4.A, which summaries proposals for the FCA objectives, noting in particular that 4.3b refers to securing an *"appropriate"* degree of protection for consumers, which recognises that the same level of protection is not necessary for all consumers.

The FOA would reiterate the observations made in paragraph 3.2 in relation to economic growth (an objective of each of the European Supervisory Authorities) as a desirable objective/factor that should be taken into account by the FCA.

4.8 FOA notes and welcomes the inclusion of the promotion of competition as an objective (to the extent compatible with the FCA's strategic and operational objectives) and, in particular, recognition of its *"positive outcomes"* (para 4.22 in the CD). However, effective competition is dependent upon, as has previously been stated, the facilitation of diversity, innovation, choice and competitiveness. The FOA believes that it is important for these factors to be taken into account – if not directly as *"objectives"* in their own right – at least by way of recognising their importance within the competition objective. They are, after all, critical to the *"positive outcomes"* of competition.

4.9 The FOA strongly supports the regulatory principles set out in para 4.23 to 4.29 and the observation in para 4.30, which the FOA believes is particularly important, that *"the regulators will be subject to the usual requirements as public bodies to act in accordance with duties arising under UK and international law"*. However, it should be clarified that these requirements will include observing the principles for good regulation that apply to UK public bodies.

4.10 The FOA does not accept that observance of the short list of regulatory principles would ensure that other desirable features of the market for financial services, such as competitiveness and innovation, will not be inappropriately compromised.

We would highlight that principle 5 in Box 3.B – "*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"* – should acknowledge <u>explicitly</u> the balance between public policy and private rights, given that publication without due consideration of the implications could have a detrimental impact on the firm(s), industry and consumer(s).

Q12. What are your views on the Government's proposed arrangements for governance and accountability of the FCA?

4.11 The FOA:

(a) welcomes the Government's intention to retain the Practitioner and Consumer Panels and to place the Smaller Businesses Practitioner Panel on a statutory footing and that to these Panels will be added a Markets Panel;

(b) welcomes the new powers to be given to HM Treasury; and

(c) assumes, from the observation that the existing provisions of FSMA will be replicated, that there will be a right of redress to the Complaints Commissioner where a complainant is not satisfied with the outcome of an internal investigation by the FCA (as indicated in para 3.12 of this response, the FOA believes that a similar process – independent of nomination by the Bank of England – should apply to complaints lodged against the PRA).

4.12 With regard to Box 4.E, which addresses the question of prudential regulation for those firms which do not fall within the scope of PRA regulation, the FOA assumes that it will be possible for the FCA to adopt a differentiated approach to prudential regulation, insofar as the firms regulated by it will not pose a threat to financial stability. Such a differentiated approach will be critically important, particularly for small- and medium-sized firms. The FOA notes that this will be addressed in further detail when FSA consults on the future operating model of the FCA.

4.13 Paras 4.43 and 4.44 of the CD set out the proposal to require the FCA to make a report to the Treasury where there is a regulatory failure. We agree that this will improve accountability. However, we are concerned that these reports – which will be laid before Parliament – may contain confidential information. It is important that proper safeguards are built in around this (including whether prior notice should be given to firms mentioned in a report), given the potential impact on individual firms and the market as a whole.

Q13. What are your views on the proposed new FCA product intervention power?

4.14 In brief, the FOA supports the proposals:

(a) that all firms will be subject to a periodic review of their governance, culture and controls and that this will be more extensive in the case of firms that pose a significant risk to the FCA's objective;

(b) for earlier regulatory oversight in the product life-cycle, but would emphasise its support for FSA's intention to reflect a proportionate approach as stated in its Discussion Paper "Product Intervention" (DP11/1), namely:

(i) its intention to *"strike the right balance between consumer protection… and the risks of restricting consumer choice and product innovation"* (para 1.24);

(ii) its recognition that *"competition and consumer choice are key aspects of an effective financial services sector"* (para 1.11);

(iii) its recognition (in its response to the European Commissions' consultation on MiFID that *"banning products of any kind should be undertaken with great caution, and only in response to specific market failures, as otherwise innovation, effective risk management and economic growth could be detrimentally impacted"*, and

(c) to ensure that disclosure as a regulatory tool will be subject to a number of safeguards *"to ensure that an appropriate balance is struck between the interest of consumers and regulated firms"* (para 4.76 in the CD).

NB. The FOA notes the Government's expectation that such a power is *"unlikely to be appropriate in relation to professional wholesale customers"*.

4.15 In terms of the target of prevention of consumer detriment, the FOA notes that this has been variously described in the CD as *"consumer detriment"*, *"significant detriment for retail customers"* and *"widespread consumer detriment"*. In view of the sensitive nature of product intervention, the FOA believes that the terminology used in the FSA's Discussion Paper should be the core justification for specific product intervention, namely, *"large-scale significant consumer detriment"*.

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.*

4.16 The FOA would note, in para 4.83, that the FCA will have a duty to publish details of a written notice to a firm to withdraw a financial promotion, where appropriate. In this context, in common with other published firm-specific notices, the FOA thinks it is critically important that any such publication is not couched in pejorative language, but carefully phrased to ensure that it is fair and accurate.

4.17 With regard to early publication of enforcement action, as set out in paras 4.85-4.89, the Government will be familiar with the deep concerns over this power that has been expressed by the regulated community.

The FOA understands the need for adequate transparency with regard to enforcement actions, although it does not accept the justification that early announcements of this nature will, as it is put in para 4.86, signal to firms *"what behaviours the regulator considers to be unacceptable"*. This should be signalled more properly through releases to firms, summaries of disciplinary actions and advance warning of increased sanctions or penalties.

4.18 As the CD recognises, there need to be a number of safeguards *"to ensure that an appropriate balance is struck between the interests of consumers and regulated firms"* (para 4.76 in the CD). This should mean that any firm which is to be the subject of any such notice should have the right to comment on its wording and the FCA should be under an obligation to set out, however briefly, the firm's response in relation to the breach in question – recognising that there has been no finding of guilt at this stage.

While the FOA supports the obligation to publish, where relevant, a *"notice of discontinuance"*, we would emphasise the fact that it will almost certainly be too late to mitigate damage caused by the original publication at this stage. Further, the FOA does not accept that the only reason why a regulator would not publish a warning notice of this nature is where it would not be compatible with its operational or strategic objectives. This comment makes no allowance for the fact that it might not be compatible in terms of fairness to the firm in question, i.e. it is not just a matter of appropriate *"safeguards"*, but the taking of a balanced decision in the first place (which is mirrored in the Government's approach to disclosure in para 4.76 of the CD).

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?

4.19 With regard to the FCA's new role and powers as regards the promotion of competition, the FOA has already commented in relation to the fact that too little regard has been paid to the importance of such factors as competitiveness and innovation. However, the FOA does welcome the Government's expectation that the FCA will use its existing regulatory tools *"more clearly in pursuit of promoting competition"* and that this will include *"the ability to make rules that will have beneficial competition outcomes"*.

4.20 The FOA also notes that the FCA will be empowered to *"agree"* legally binding commitments with the industry, rather than making any referrals to the Competition Commission and, in this context, the word *"agree"* is particularly important. However, it is important that the FCA does not, of itself, have the power to usurp the authority of the competition authorities and, in the view of the FOA, it would be certainly inappropriate to grant functional powers to any of the panels, including the Consumer Panel.

The Department for Business, Innovation and Skills has launched a far reaching consultation on competition in the UK: A *Competition Regime for Growth: A Consultation on Options for Reform.* We note that this consultation document refers to the fact that the Government "*is considering whether concurrent competition powers should be extended to the future Financial Conduct Authority (FCA)."*

Given the fundamental changes that are likely to result from this consultation, in particular, the merger of the Office of Fair Trading (OFT) and the Competition Commission to form the Competition and Markets Authority (CMA), we consider it premature to discuss the FCA's role in respect of competition in any degree of detail. If there is to be a significant overhaul of the competition framework, adding powers at the FCA level will need to be achieved harmoniously with the CMA.

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*

4.21 With regard to wholesale markets regulation, the FOA has already expressed its strong support for the Government's recognition of the need for a differentiated approach and that exercise of interventionist powers are likely to be less appropriate in the context of wholesale conduct regulation.

More particularly, the FOA notes the observation in para 4.104, that *"Given the contribution made by wholesale markets, not only to the position of London as a global financial centre, but also their importance to the economy as the mechanism by which capital is raised and risk managed, it will be vital to ensure that their regulation continues to be effective and proportionate".*

The FOA would urge that this recognition is properly reflected in the regulation of wholesale market business.

4.22 The FOA supports the Government's approach towards the conduct and prudential regulation of recognised investment exchanges and the operators of multilateral trading facilities and welcomes the retention of the Part XVIII regime for recognised bodies, subject to the proposed technical improvements.

5. Regulatory Processes and Co-ordination

Q17. What are your views on the mechanisms and processes proposed to support effective co-ordination between the PRA and the FCA?

5.1 The FOA welcomes the assurances in the CD that further detail on operational co-ordination and the scope of operations of each of the PRA and the FCA will be announced later in the Spring.

5.2 The FOA supports the governing principle for co-ordination set out in para 5.6 of the CD. As noted in para 1.4 of this response, a key issue for our members is to encourage the development of appropriately detailed MoUs to facilitate efficient supervision, particularly of firms which are going to be dual regulated. We would also urge the inclusion of timeliness as a criterion for effective information-sharing, co-ordination, decision-making and action.

5.3 While, as is suggested in the third indent of para 5.6 in the CD, regulatory overlap or duplication must be "managed in a proportionate way", it should, like regulatory "underlap", also be avoided, but only where it is possible. This is in the interests of avoidance of unnecessary regulatory cost.

5.4 The FOA agrees with the observations in para 5.8 of the CD and, in particular, that effective co-ordination is heavily dependent upon flexibility, but there will still need to be clear parameters and criteria – which need not constitute onerous or bureaucratic processes – to ensure that effective co-ordination actually takes place and setting it in the context of specific obligations.

5.5 With regard to the comments in paras 5.9-5.12 on the statutory duty to co-ordinate, the FOA would, again, repeat its observations that there should be an express obligation for each regulator to pay due regard to the statutory objectives of the other regulator. The risk of conflict in this area is self-evident, particularly where one regulator is reluctant to pursue the recommendations and urgings of another regulator. The FOA does not believe that the obligation to consult to manage their process efficiently – as set out in para 5.11 – addresses this issue adequately.

By way of comparison, para 5.18 in the CD, when addressing the management of firm failure or threats to financial stability, specifically states that, in this area, regulators *"must take account of these views"*, i.e. the achievement of the others' objectives. If this is deemed appropriate in terms of firm failure, we would argue that it should also be included in terms of other areas of coordination

5.6 The FOA supports the proposals with regard to Memoranda of Understanding and cross-membership of boards.

5.7 Significant reliance is placed on MoUs to facilitate efficient and robust coordination and we would note that these alone will not be sufficient but must be backed up with rigorous implementation mechanisms. There needs to be complete clarity with respect to all the authorities' regulatory powers and processes and we would urge the Government to give the industry an opportunity to comment on the MoUs. Service level standards for the PRA and FCA should be determined and published in order to provide a measurable indicator of efficacy.

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?

5.8 The FOA agrees with the proposals for managing the risk of disorderly firm failure as set out in paras 5.18-5.26 and welcomes the fact that the power of the PRA to prevent the FCA from taking actions that could lead to the *"disorderly failure of a firm"* will be *"limited", subject to transparency and accountability obligations.* We would, however, highlight, as the Government will no doubt be well aware, that the act of laying the veto before Parliament would be a very strong market signal that something very serious was happening to a regulated firm, and the regulators could not agree what to do about it. This would not assist confidence in the market and would damage the credibility of the authorities. It is therefore critical this power is used only *in extremis*.

Q19. What are your views on the proposed models for the authorisation process – which do you prefer and why?

5.9 We support the **alternative approach**.

Under the alternative approach, the Government proposes that either the FCA could take the lead for processing all applications or the prudential authority for a firm would lead on the processing. Our concern with the second proposal (that the prudential authority would lead) is in relation to investment firms where the criteria regarding whether they fall in or out of the PRA's scope is more fluid and could conceivably change if an investment firm expanded or decreased. To mitigate against confusion and uncertainty, we would advocate that the FCA leads on processing applications for all investment firms and coordinates with the PRA.

Q20. What are your views on the proposals on variation and removal of permissions?

5.10 The FOA believes, in regard to the Voluntary Variation of Permission, that it will be inefficient and costly for dual-regulated firms to apply to both the PRA and the FCA separately. We believe a streamlined approach should be followed where only one authority deals with the two regulatory processes. Our preference is for the *alternative approach* set out under para 5.38 of the CD where one authority is charged with processing each authority's application.

5.11 For dual regulated firms, we believe the PRA and the FCA should have a statutory duty to consult with each other and reach agreement before exercising their Own Initiative Variation of Permission powers.

Q21. What are your views on the Government's proposals for the Approved Persons regime under the new regulatory architecture?

5.12 We consider that the proposals for the approved persons regime - although they recognise and attempt to resolve the overlap between the scope of the PRA and the FCA - lack clarity and require further thought. We would see the benefit of a shared back office function which could process the applications and reach out to both the PRA and FCA for their approval where the controlled function spans both authorities' remit. Notwithstanding this suggestion, we would propose that processing approved persons applications is subject to the alternative approach (see our response to Question 19 above) so that there is one entry point for firms, for consistency and efficiency.

Q22. What are your views on the Government's proposals on passporting?

5.13 The FOA supports the approach to "passporting" and, while it is content for the PRA to assess the impact of cross-border firms activities on UK financial stability, the basis on which it may take action to address those activities should be the subject of transparent criteria so that those firms are able to properly assess the consequences of their cross-border dealings. Again this is where we would see the benefit of a shared back office function, as noted in para 5.12 of this response.

Q23. What are your views on the Government's proposals on the treatment of mutual organisations in the new regulatory architecture?

5.14 The FOA very much supports the view that regulatory authorities should not seek to *"promote or favour one type of ownership model over another"* and the obligation to undertake an analysis of the costs that will arise from any proposed rules in terms of the extent to which they will impact on mutually-owned institutions (although this requirement is self-evidently relevant to all rule-making in terms of its application to any particular type of institution, irrespective of its ownership model).

Q24. What are your views on the process and powers proposed form making and waiving rules?

5.15 On rule-making:

We agree that: "*Both the PRA and the FCA [should] have the statutory power to make rules that apply to regulated firms within their jurisdiction*" subject to the over-ride that "*the authorities will only be able to make rules in pursuance of their objective*." However:

(a) We are concerned that the rule-making process outlined has the potential to cause confusion and uncertainty for dual-regulated firms, as it states both the PRA and FCA may make rules applying to the same function e.g. systems and controls. In addition, as both the PRA and FCA will regulate firms from a prudential standpoint, it remains unclear whether a single set of prudential regulations will be developed, which would be our preference. At the least, we would urge the Government to mandate that all investment firms within a group should be prudentially supervised by the same regulatory authority and subject to one prudential rulebook only.

(b) We believe an efficient coordination mechanism around rule-making is required to avoid under and overlap and conflicting rules. We would suggest a joint rule-making committee (as proposed by AFME in its response), with joint (PRA and FCA) rules and guidance in relation to the overarching high-level regulatory standards such as SYSC and common regulatory processes (c.f. the FSA's Supervision manual). These joint rules should overarch and form part of, both the PRA and the FCA's handbooks.

5.16 On rule-waivers:

We agree it is appropriate for both the PRA and the FCA to have such powers in relation to their own rules. In relation to dual regulated firms, it should be mandated that the authorities must first consult with each other before approving such rule waivers.

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*

5.17 With regard to the paragraphs addressing on-going supervisory processes, namely paras 5.59-5.85, the FOA supports the focus on the need for a consistent and co-ordinated approach between the PRA and the FCA, and that their rule-making scope should focus on the pursuance of their objectives, but would make the additional observations:

(a) With regard to the proposals for supervision of financial groups (paras 5.65-5.72), the FOA very much supports the conditions and limitations on the power of direction that the authority for consolidated supervision will have over the other authority, namely, that it is necessary to ensure effective consolidated supervision and that it will apply only in relation to the authorised entity within the group.

(b) In the matter of the exercise of powers of direction over unregulated holding companies, the FOA agrees the limits and safeguards set on the exercise of any power of direction and that, in the case of a mutual PRA/FCA interest in the firm in question, there will be consultation between the authorities prior to the issuance of any direction.

(c) As the Government recognises, it is still somewhat unclear which investment firms will be subject to PRA supervision. In the interests of efficient, co-ordinated supervision, all the investment firms within a group should be prudentially supervised by the same regulatory authority. It is not clear from the consultation that this will necessarily be the case.

Q26. What are your views on proposals for the new authorities' powers and co-ordination requirements attached to change of control applications and Part VIII transfers?

5.18 We have no comments to make.

Q27. What are your views on the Government's proposals for the new regulatory authorities' powers and roles in insolvency proceedings?

5.19 We understand the rationale for each authority having the power to bring insolvency proceedings. We support the provision that the prior consent of the Bank be required and that the PRA be given the opportunity to exercise its veto in the case of proposed action by the FCA.

Q28. What are your views on the Government's proposals for the new authorities' powers in respect of fees and levies?

5.20 The FOA would reiterate that, in order for the CD's objectives to ensure that *"it will be essential for the PRA and the FCA to use their resources efficiently in order to keep their costs down"* – and that means avoidance of unnecessary duplicative costs – it remains important that the fee-setting process is subject to independent oversight. In this context, the FOA particularly notes the concerns expressed in the CD that this will be a significant issue for those *"smaller firms which will be subject to regulation by both authorities, and so will have to pay two sets of fees"*.

While the question of size is important here, the principle is no different for larger firms that will have to also pay two sets of fees.

5.21 The requirement for co-ordination and proportionality is very much supported, but the risk of overlap and duplication is very real, and that could spill over into the fees set by each authority.

5.22 The FOA supports the idea that fees should be collected by one organisation.

6. Compensation, Dispute Resolution and Financial Education

Q29. What are your views on the proposed operating model, co-ordination arrangements and governance for the FSCS?

6.1 The FOA agrees that the Financial Services Compensation Scheme (FSCS) has an important role to play in sustaining consumer confidence, but would question that its role extends through to *"promoting financial stability through effective resolution"*.

6.2 The FOA supports the Government's intention to place the need for an MOU with both regulators on a statutory footing – but, given that the MOU will be wide-ranging and effective, it would seem appropriate for the FCA to adopt a lead-regulator role on the basis that it would consult regularly with the PRA.

Q30. What are your views on the proposals relating to the FOS, particularly in relation to transparency?

6.3 The FOA supports the proposals, but would suggest that there may be merit – in view of the substantial increase in the number of complaints – in undertaking a review of those that failed in order to determine what percentage of those failed complainants were vexatious without merit (and may have been simply instigated at no cost to a retail consumer in order to persuade a defendant to settle an unmeritorious claim to avoid the costs of the hearing).

6.4 The FOA would urge HM Treasury to consider the appropriateness of establishing a "facts and merit" appeals mechanism, rather than expecting mitigants to rely only on the right of judicial review, which is focussed on process.

7. European and International Issues

Q32. What are your views on the proposed arrangements for international co-ordination outlined above?

7.1 The FOA welcomes the clear recognition that significant UK input is essential in terms of the setting of European and international standards, and that the Government will constantly be looking to take a leadership role in this area. This will require significant input, however, from ministers and senior Government officials.

7.2 As it is put in para 7.9 in the CD, *"The Government expects the UK's regulatory agencies to put significant time and effort into ensuring that the UK's voice is heard at the European level and that the decisions taken by the new authorities are appropriate"*. Building up voting "coalitions" within key EU institutions will be critical if that voice is to be properly heard.

7.3 In view of the fact that there is no precise match between the new UK regulatory infrastructure and the European Supervisory Authorities, it is essential – and this is recognised in the CD – that there is full prior consultation between the UK regulatory authorities and that, wherever appropriate, each authority takes advantage of the right for the UK member authority to be accompanied by a non-voting observer.

7.4 The FOA supports the Government's proposal to legislate to ensure that a comprehensive MOU is drawn up between the Treasury, the Bank of England, the PRA and the FCA to address the need for effective international co-ordination.

8. Next Steps

8.1 The FOA notes the Government's target of putting the new regulatory architecture in place by the end of 2012 and the importance of having a clear timeline, but as the Treasury Select Committee has pointed out, getting the construct right is more important than fulfilling a set timetable. This tension between qualitative deliverables and fixed timetables has been a particular problem at the European level, and the need for flexibility and pragmatism is important, particularly in rebuilding the UK's financial services infrastructure. "Getting it right" is, surely, the first priority.

8.2 The FOA supports the Government's assurances:

- to publish a White Paper in the Spring (subject to the points made above);
- to engage in further consultation and issue more detailed releases as referred to in the CD;
- to convene a joint committee of MPs and peers to scrutinise the draft legislation (comparable to the approach adopted in relation to the Financial Services Markets Act);
- to "road-test" key elements of the new supervisory structure and, particularly, that the outcomes of that process will be fully taken into account and reviewed against the proposed timeline on an on-going basis.

APPENDIX 1

LIST OF FOA MEMBERS

FINANCIAL INSTITUTIONS

ABN AMRO Clearing Bank N.V.
ADM Investor Services International Ltd
AMT Futures Limited
Bache Commodities Limited
Bank of America Merrill Lynch
Banca IMI S.p.A.
Barclays Capital
Berkeley Futures Ltd
BGC International
BHF Aktiengesellschaft
BNP Paribas Commodity Futures Limited
Capital Spreads
Citadel Derivatives Group (Europe) Limited
Citigroup
City Index Limited
CMC Group Plc
Commerzbank AG
Crédit Agricole CIB
Credit Suisse Securities (Europe) Limited
Deutsche Bank AG
ETX Capital
Fortis Bank Global Clearing NV - London
GFI Securities Limited
GFT Global Markets UK Ltd
Goldman Sachs International
HSBC Bank Plc
ICAP Securities Limited
IG Group Holdings Plc
Investec Bank (UK) Limited
JB Drax Honoré
JP Morgan Securities Ltd
Liquid Capital Markets Ltd
Macquarie Bank Limited
Mako Global Derivatives Limited
MF Global
Marex Financial Limited
Mitsubishi UFJ Securities International Plc
Mizuho Securities USA, Inc London
Monument Securities Limited
Morgan Stanley & Co International Limited
Newedge Group (UK Branch)
Nomura International Plc
ODL Securities Limited
Rabobank International
RBS Greenwich Futures
Royal Bank of Canada
Saxo Bank A/S
S E B Futures
Schneider Trading Associates Limited
S G London
Standard Bank Plc
Standard Chartered Bank (SCB)
Starmark Trading Limited
State Street GMBH London Branch
The Bank of Nova Scotia
The Kyte Group Limited
Tullett Prebon (Securities) Ltd
UBS Limited
Vantage Capital Markets LLP
Wells Fargo Securities International Limited
WorldSpreads Limited

EXCHANGE/CLEARING HOUSES

APX Group
Bahrain Financial Exchange
CME Group, Inc.
Dalian Commodity Exchange
EDX London
European Energy Exchange AG
Global Board of Trade Ltd
ICE Futures Europe
LCH.Clearnet Group
MEFF RV
NYSE Liffe
Powernext SA
RTS Stock Exchange
Shanghai Futures Exchange
Singapore Exchange Limited
Singapore Mercantile Exchange
The London Metal Exchange
The South African Futures Exchange

SPECIALIST COMMODITY HOUSES

Amalgamated Metal Trading Ltd
Cargill Plc
ED & F Man Commodity Advisers Limited
Engelhard International Limited
Glencore Commodities Ltd
Koch Metals Trading Ltd
Metdist Trading Limited
Mitsui Bussan Commodities Limited
Natixis Commodity Markets Limited
Noble Clean Fuels Limited
Phibro GMBH
RBS Sempra Metals
Sucden Financial Limited
Toyota Tsusho Metals Ltd
Triland Metals Ltd
Vitol SA

ENERGY COMPANIES
ALPIQ Holding AG
BP Oil International Limited
Centrica Energy Limited
ChevronTexaco
ConocoPhillips Limited
E.ON EnergyTrading SE
EDF Energy
EDF Trading Ltd
International Power plc
National Grid Electricity Transmission Plc
RWE Trading GMBH
Scottish Power Energy Trading Ltd
Shell International Trading & Shipping Co Ltd
SmartestEnergy Limited

PROFESSIONAL SERVICE COMPANIES
Actimize UK Ltd
Ashurst LLP
Baker & McKenzie
Barlow Lyde & Gilbert
Berwin Leighton Paisner LLP
BDO Stoy Hayward
Clifford Chance
Clyde & Co
CMS Cameron McKenna
Complinet
Deloitte
Dewey & LeBoeuf LLP
Exchange Consulting Group Ltd
FfastFill
Fidessa Plc
Financial Technologies India
FOW Ltd
Freshfields Bruckhaus Deringer
Herbert Smith LLP
Hunton & Williams LLP
International Capital Market Association
ION Trading Group
JLT Risk Solutions Ltd
Katten Muchin Rosenman Cornish LLP
KPMG
Mpac Consultancy LLP
Norton Rose LLP
Options Industry Council
PA Consulting Group
R3D Systems Ltd
Reed Smith LLP
Rostron Parry Ltd
RTS Realtime Systems Ltd
Sidley Austin LLP
Simmons & Simmons
SJ Berwin & Company
SNR Denton UK LLP
Speechly Bircham LLP
SunGard Futures Systems
Swiss Futures and Options Association
Total Global Steel Ltd
Traiana Inc
Travers Smith LLP
Trayport Limited

7 April 2011

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

By email to:
financial.reform@hmtreasury.gsi.gov.uk

Dear Sirs

GC100 response to HM Treasury's Consultation: "A new approach to financial regulation: building a stronger system"

I am writing on behalf of the GC100 in response to HM Treasury's Consultation, "A new approach to financial regulation: building a stronger system" (Cm 8012: February 2011). As you may be aware, the GC100 is the association for general counsel and company secretaries of companies in the FTSE100. There are currently more than 120 members of the group, representing some 90 issuers.

The GC100 welcomes the opportunity to respond to this consultation, with particular reference to the proposal set out in Chapter 4 of the consultation relating to Market Abuse, Part VI of FSMA and to Listing and the UKLA. We have limited our response to question 16 and our observations to matters relating to Market Abuse, Listing and the UKLA.

We were pleased to note that the UKLA should remain part of the FCA. However we were surprised to discover potentially far reaching and onerous changes being proposed in relation to the statutory framework surrounding primary and secondary market activity in Part VI of FSMA described in the language of 'minor technical improvements'. As a general observation we do not consider there to have been market or regulatory failure in the listed markets and we fear that changes justified as technical changes could have a significant and adverse impact and such changes are not justified on regulatory grounds or as a result of any actual market failure. Indeed we think the listing regime stood up well during times of extreme stress during the financial crisis.

GC100 Group
The Association of General Counsel and Company Secretaries of the FTSE 100
The GC100 Group is an unincorporated members' association administered by the Practical Law Company Limited

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In particular certain changes are justified on the grounds of alignment with other aspects of FSMA or FSA/FCA responsibilities. We are worried by this approach as we think the role of the UKLA as competent authority for listing and prospectuses is, by its very nature, fundamentally different from the prudential, supervisory, conduct and consumer aspects of the FSA/FCA. This is explored more fully below in relation to statutory objectives and also limitation periods.

Listing and the UKLA

We believe that the Government's central policy objectives as outlined in the consultation, namely, to enhance the UK's financial stability and to avoid regulatory failure contributing to another financial crisis, are sound.

However the consultation deals not only with the regulatory structure for banks and other financial institutions, but also with the structure of primary and secondary market regulation for equity and debt in the UK. This is quite a different issue, as the structure of UK markets affects the attractiveness of those markets for investors and therefore the capability of all companies (not just financial institutions) to raise finance competitively and efficiently, as well as being relevant to the competitiveness of the UK as a centre for investment and a market for capital raising by international companies. Strong and effective UK market regulation is a key ingredient for the continued strength and efficiency of the UK capital markets as a source of capital for business.

The main change to the listing regime and other primary market regulation will be to bring it under the general legislative framework of the FCA (rather than being solely contained in a discrete part of the statute), including by extending the application of the objectives and regulatory principles to the general functions under Part VI

We do consider that the FCA is a more appropriate home for the UKLA than a separate regulator suggested in a previous document, particularly in an increasingly European policy environment. However we also consider that the regulatory focus and priorities of the UKLA are, and should remain, different from those of the rest of the FCA. Primary and secondary market regulation is based strongly on market transparency designed to enable investors to make decisions in an appropriate timeframe and based on the correct information (via prospectuses, RIS disclosures or annual/interim reports). This ties into market abuse regulation but has very little linkage to supervisory, prudential or conduct regulation which will be the main focus of the FCA.

On this basis we believe that the decision to try and bring the UKLA and Part VI within the general legislative framework of the FCA rather than retaining a discrete Part VI regime is misguided and unlikely to lead to any positive benefit in terms of protecting or enhancing confidence in the UK financial system. We believe a function like the UKLA needs to have a UK competitiveness focus in terms of objectives and that, whilst possibly appropriate for a prudential and conduct regulator, the FCA objectives are not appropriate for a market/transparency type regulator. We believe that the 'have regards to' duties set out in section 73 of FSMA remain appropriate for the different kind of regulatory function the UKLA carries out which is neither prudential nor conduct based.

We appreciate that the FSA and HM Treasury may feel this kind of approach to statutory objectives and responsibilities may in some way be responsible for regulatory failures over the past few years. In a supervisory and prudential context this may be the case. However we do not believe it is appropriate to take this approach with primary market regulation. The general role and obligation of the UKLA is to ensure appropriate disclosure by issuers at the correct time and then the market and securities holders can make decisions, including decisions to take legal action against issuers if they believe the information is lacking in any material respect, based on such information.

In short we think the listed markets and UKLA will benefit from the FCA, in its capacity as UKLA, having objectives and 'have regard to' factors more closely aligned to those set out in section 73 of FSMA than those proposed for the FCA which do not appear appropriate to us to a market and disclosure based regulator.

Allowing the UKLA to discontinue or suspend a listing at the request of an issuer without following the warning notice and decision notice procedure – these procedures are onerous and unnecessary when the UKLA is agreeing to a request made by the issuer

We agree that these changes are onerous and unnecessary and welcome any change to put this regime on a more practical and understandable footing.

Extending the UKLA's powers to impose sanctions on sponsors for breaches of UKLA rules and requirements imposed on sponsors

This is not a matter on which the GC100 has specific views. We would be concerned if this led to an increase in fees for sponsors if they anticipate additional risk or cost in listed transactions. Again we are not aware of specific failings in sponsor firms which justify this new proposal.

Extending the limitation period for taking action for breaches of the listing rules from two to three years

As with our previous comments on the statutory aspects of Part VI of FSMA, we feel the current approach to Part VI and UKLA has worked well and we see no reason why it should be considered correct to read across any aspects of the UKLA powers to other parts of FSMA, the FSA or the FCA. Any change has to be justified on market failure and cost benefit analysis. Justifying changes on the basis of housekeeping and alignment with the rest of the FSA/FCA are in our mind fundamentally incorrect.

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Enabling the UKLA to obtain information from issuers by requiring an issuer to have a skilled person prepare a report on a matter which the UKLA requires information

We see this as a significant increase in the powers and regulatory toolkit of the FSA/FCA without any real justification or understanding of market failure or cost benefit analysis which has led to this significant policy development. This power could materially alter the whole approach of the listed market and the UKLA to each other and does not appear justified in our minds. We are worried that such powers, once in existence, will be used frequently and for matters which may be considered immaterial. We would suggest that rather than being a 'less onerous' way of dealing with enforcement or pre-enforcement matters this regulatory tool is much more likely to be used regularly to deal with matters which are dealt with through dialogue and correspondence presently.

We would see this as adding to the regulatory burden and cost of being listed in the UK, specifically for debt and specialist securities issuers. This may be appropriate power, if used sparingly and sensibly, in relation to authorised firms but we do not consider this to be an appropriate tool for listed issuers and markets. It also appears to be the kind of tool which prudential and conduct regulators are becoming increasingly attracted to – the benefits of this are less clear.

The area where the UKLA will want to use these powers (if it is given to them) is to establish whether the Listing Principles are being complied with. When the Listing Principles were introduced the market was assured by the UKLA that they had no intention of enforcing the principles independently of a substantive breach of one of the other rules. We do not see any change in relation to the functioning of listed issuer markets which suggests this radical and costly change is justified and the UKLA has no need for these powers.

One of the consequences of this procedure is that a firm may be guilty of no misconduct but still have to pay, sometimes very large amounts, to consultants to review and report on the way they achieve compliance. That may be appropriate for authorised firms where compliance with general requirements for systems and procedures are fundamental to their ability to comply with the rules, such a power is disproportionate when applied to listed issuers.

Giving the UKLA power to make rules or impose sanctions on primary information providers (organisations which channel information from issuers to the UKLA and announce information to the market)

We have no specific comment to make in relation to this matter but would again be concerned to understand the justification for the increased regulation and that this be balanced against an inevitable increase in cost arising from regulation/overregulation.

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Summary

We strongly urge HMT reconsider the approach to try and shoehorn listing and the UKLA into the mainstream of FCA process, procedure and regulatory approach. Listed issuers do not have to deal with customers for whom special protections are appropriate and to whom special duties should be owed, the supervision and enforcement of which may involve a detailed examination of the business of the firm concerned. Instead, the regulatory regime for which the UKLA is responsible is much more a "rules of the road" system where those who transgress should be brought to account through a process of enforcement. This should be reflected in distinct statutory objectives and ‘have regards’ to factors and a clear recognition that skilled persons reports are not appropriate for the listed issuer environment. The balance which ensures that London remains an attractive environment for equity and debt capital raisings is delicate, is only tangentially and in a minor way linked to the financial crises, and competitiveness can only be threatened by this kind of unjustified regulatory creep.

Please note that the views expressed in this letter do not necessarily reflect the views of each and every member of the GC100 or their employing companies.

If you have any questions, please do not hesitate to contact me.

Yours faithfully,

Mary Mullally
Secretary, GC100

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N.B. Where questions are such that they are outside of the scope of Genworth's business, we have not responded.

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

The instruments proposed are likely to prove more effective than the current arrangements. Whilst the impact on firms is likely to vary, it seems that the financial services sector will gain a net benefit overall.

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

In addition to LTV caps as discussed in cause 2.63, the use of Mortgage Indemnity Insurance should be considered as a proven, effective macro-prudential tool. This would be consistent with recent recommendations by both the IMF (IMF report extract*) and FSB mortgage peer review§:

> Appropriate LTV ratios are an important and effective means to mitigate the risks of residential mortgage portfolios. Supervisory guidelines generally direct institutions to obtain credit support for high LTV residential mortgages, typically defined as greater than 80% of the property's appraised value. Appropriate credit support includes mortgage insurance, readily marketable collateral or other acceptable collateral that reduces the LTV ratio. Moreover, most FSB members attempt to incentivise LTV limits by offering capital relief for loans with low LTV ratios through risk-weight differentials.

As has proven effective in other European jurisdictions and elsewhere, consideration could be given to differential treatment of assets where MII is used as credit risk mitigation, allowing firms a degree of flexibility in their risk models. This would work in conjunction with Variable risk weights, as proposed in clause 2.53, to provide more effective macro-prudential controls.

In some countries, such as Canada and Hong Kong[1], MI is used as a macro-prudential tool that improves the performance of residential mortgage loans, helps to moderate house prices, and, as a consequence, contributes to a safer and sounder financial system. Mortgage insurers play an active role at the underwriting stage of mortgage loans, ensuring that prudent criteria are met by borrowers, and periodically auditing the different mortgage portfolios in order to monitor closely the performance of such portfolios period, these audits, in many cases, serve as early indicators which allow both the lender and the MI provider to take prudent corrective actions in their lending processes.

In January 2010, the Joint Forum[2], after analysing the main reasons that contributed to the financial crisis, and identifying the erosion of underwriting standards as one of them, recognized the role of MI and recommended its use:

> **Recommendation n° 7:** Supervisors should ensure that mortgage originators adopt minimum underwriting standards that focus on an accurate assessment of each borrower's capacity to repay the obligation in a reasonable period of time. The minimum standards adopted should be published and maintained in a manner accessible to all interested parties. (…)

[1] See [1] J. Kiff, et al. (2010), "How the Canadian Housing Finance System Performed through the Credit Crisis"; and, [3] E. Wong, et al. (2011), "Loan-to-Value Ratio as a Macro-Prudential Tool. Hong Kong's Experience and Cross-Country Evidence" for a description of the mortgage market in Canada and in Hong Kong, respectively.

[2] See [2] The Joint Forum (2010), "Review of the Differentiated Nature and Scope of Financial Regulation. Key Issues and Recommendations".

* http://www.imf.org/external/pubs/ft/gfsr/2011/01/pdf/chap3.pdf

§ http://www.financialstabilityboard.org/publications/r_110318a.pdf

Mortgage insurance. Mortgage insurance provides additional financing flexibility for lenders and consumers, and supervisors should consider how to use such coverage effectively in conjunction with LTV requirements to meet housing goals and needs in their respective markets. Supervisors should explore both public and private options (including creditworthiness and reserve requirements), and should take steps to require adequate mortgage insurance in instances of high LTV lending (eg greater than 80 percent LTV).

3 Do you have any general comments on the proposed role, governance and accountability mechanisms of the FPC?
The composition of the FPC (and in fact all other regulatory committees) should accurately reflect the range of participants in the markets they oversee. Under the current structure, wholesale and investment banking is over represented in a number of key areas and retail financial services is consequently under represented. The new regulatory structure is an opportunity to correct this imbalance.

In relation to the breadth of responsibility of the BoE, including its governance role for the FPC, please see our response to Q8.

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

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

i) strategic and operational objectives

we are broadly supportive of these.

ii) the regulatory principles proposed for the PRA?

We have concerns about a reduction in the principles aimed at maintaining a competitive financial services sector in the UK which can facilitate innovation and maintain the UK as a world-leading financial centre.

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?
With regard to the PRA's prioritisation of 'dealing in investments as principal' firms, the key mechanism will be the proposed 'objective criteria' and the PRA's application of this, so we await further details of this.

More generally, there is a risk of that the regulation of the insurance sector may be seen as a backwater within the Bank of England/FPC as well as the PRA, with a lack of focus and developed expertise within the regulators. The likely effect of this, which would be strongly detrimental to the UK public interest, is that inexperienced supervisors will tend to be conservative in their prudential expectations, loading UK insurers with excess capital leading directly to a lack of international competitiveness.

Prudential requirements are increasingly international through the Solvency 2 process, however they still involve elements of judgement requiring high quality analysis at both entity and national levels.

We believe that HMT should be very robust in setting a clear expectation that the relevant department of the PRA should become a genuine centre of excellence with regards to insurance regulation and supervision, whether that be at the macro-prudential level, in dealings with individual entities or in dialogue with the new European Supervisory Authorities.

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 principle of judgement led regulation and 'judgements on judgements' seems to be an appropriate regulatory mechanism, provided that (in our view) five essential challenges are overcome:

- The basis upon which judgements are made is a well defined and transparent process;
- The quality and quantity of staff undertaking supervisory assessments and subsequent judgements is maintained at appropriate levels
- There is consistent application of judgements between firms operating in similar circumstances and markets
- There is a valid intervention and/or appeals process, should things go wrong;
- Judgements based on future market conditions are not applied retrospectively by any regulatory authority, including the FOS

With regard to the proposed changes to rule making, it may prove to limit the PRA's range of future regulatory tools if the power to make statutory guidance is removed.

8 What are your views on the proposed governance framework for the PRA and its relationship with the Bank of England?
The regulatory responsibility vested in the Bank of England will be considerable, as well as representing a substantial increase from current areas of responsibility. This raises broader questions for Government as to the overall accountability of the Bank of England, when the whole of the financial sector is ultimately its responsibility day-to-day.

9 What are your views on the accountability mechanisms proposed for the PRA?
Whilst broadly supportive of the mechanisms proposed, there seems to be a slight disconnect between the proposals for a proactive, judgement-led regulator and the accountability proposals, which appear to be primarily reactive and 'by exception', external review or in the event of failure. We believe it would add value, transparency and improved accountability for the PRA to be required to report in broader terms (and on a more frequent basis than is current practice) on its areas of focus, concern and risk, as well as publishing routine activity reports.

10 What are your views on the Government's proposed mechanisms for the PRA's engagement with industry and the wider public?
We believe that it is appropriate to retain the safeguards provided by the existing consultation processes. In relation to cost benefit analyses, it hoped that the lessons learnt from the flawed CBA assumptions of the FSA's mortgage market review will be applied to future consultations.

Concerns have been expressed by consumer groups as well as industry as to the potentially significant additional ongoing costs of the proposed 'twin peaks' structure. To address these concerns, consideration should be given to quantification and review of the cost-effectiveness of the new regime and the impact on product prices, borne by consumers, both at the outset and as a regular review mechanism via the NAO.

11 What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the FCA?
Please refer to the response to Q5.

In addition, in separating out the original objectives and principles of the FSA between the PRA and FCA, certain current principles have been removed, with limited explanation as to why key considerations such as encouraging competition and facilitating innovation are no longer valid for the new regulatory system. This narrow focus for the new framework could, in the long term, have a detrimental effect on the position of the UK as a global financial centre.

12 What are your views on the Government's proposed arrangements for governance and accountability of the FCA?
The current proposals would benefit from placing more emphasis on the independence of the FCA, something we believe to be an important principle of the new structure.

Please also refer to the response to Q9

13 What are your views on the proposed new FCA product intervention power?
The principle of early intervention, before systemic problems arise, is sound. This significant shift in approach will require a much more collaborative approach from FCA, working with firms at different stages in the product lifecycle. This may require different skill sets and potentially a significant investment in resources, including management and staff, both for firms and the FCA. Inevitably, these costs will be reflected in product prices and the consumer bears that cost.

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.**

The potential for 'unintended consequences', as described in clause 4.76, should not be underestimated. It is not clear from the consultation how the disclosure proposals will be structured as to be workable in practice. One of the greatest challenges, both for regulators and firms, is retrospective analysis and learning the lessons of past mistakes. By allowing early disclosure of warning notices, the opportunity for the FCA to reflect during the process is removed, increasing the risk of large-scale errors which may result in firm failures or worse, should public confidence be adversely affected.

In addition, it is unlikely that notices of discontinuance will receive the same level of press coverage as warning notices and this could cause considerable reputational damage to firms. The risk of regulators having to pay redress is a concern, as ultimately this cost will be borne by the consumer.

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?
Whilst the wider competition responsibilities for the FCA as proposed in the consultation seem appropriate, some of the rationale discussed in clauses 4.92 and 4.93 may be flawed. Referring back to the FSA's own publications during its investigation of PPI through themed visits suggest that a more targeted, interventionist approach could have been adopted within the existing regulatory framework, but the FSA decided at first to encourage an industry-led solution.

It is also not clear from the consultation as to the division of competition responsibilities once the proposals for the new competition body, the CMA, are implemented.

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.**

n/a

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

Greater definition seems to be required, possibly with wider consideration given to the opportunities for integration and co-operation, such as shared services for processing Applications etc. (see response to Q26)

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 support these proposals. It is important that one regulator can ultimately take responsibility in extreme circumstances.

19 What are your views on the proposed models for the authorisation process – which do you prefer, and why?
Whilst both approaches are a compromise, this is an inevitable consequence of having two separate regulators, rather than implementing a 'twin peaks' approach within one regulator. As proposed in the response to Q26, a lower cost and more efficient option would be a shared services operation, possibly operated by the FCA.

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 persons regime under the new regulatory architecture?
22 What are your views on the Government's proposals on passporting?
As detailed in response to Qs 17, 19 ad 26, the complex arrangements proposed under Qs 20 to 22 would be greatly simplified by a shared service operation.

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

24 What are your views on the process and powers proposed for making and waiving rules?
These seem complex, but also an inevitable consequence of separating the prudential and conduct regulators.

25 The Government would welcome specific comments on

iii) proposals to support effective group supervision by the new authorities – including the new power of direction;

As this is effectively a continuation of current practice, it appears to be a common sense approach, subject to appropriate levels of co-ordination between PRA and FCA.

iv) proposals to introduce a new power of direction over unregulated parent entities in certain circumstances?

Provided such power is clearly defined in law, it appears to be an appropriate regulatory tool.

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?
It is our view that consideration should be given to the setup of a shared services arrangement, as an alternative proposal, to allow for coordination and consistency in these and other areas, as detailed above.

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

28 What are your views on the Government's proposals for the new authorities' powers in respect of fees and levies?
See response to Q26.

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

30 What are your views on the proposals relating to the FOS, particularly in relation to transparency?
We welcome further clarity for the role of the FOS and the further consideration planned to differentiating the respective roles of the regulator and the FOS. We await the planned consultation with interest.

There is growing concern in the financial services industry generally that the current limited accountability of the FOS may be detrimental to the fair treatment of consumers. Government may wish to consider further measures to improve FOS accountability, such as an independent review panel or some form of appeals process for firms. Many of the concerns relating to the FOS are around the consistency of approach and quality of judgements made, which may help to inform the Government as the regulatory framework moves towards a judgment-led approach.

31 What are your views on the proposed arrangements for strengthened accountability for the FSCS, FOS and CFEB?
We welcome the proposed role of the National Audit Office, but see also response to Q10 and Q30.

32 What are your views on the proposed arrangements for international coordination outlined above?
With the differing objectives of the PRA and FCA and the added involvement of BoE/FPC, there is an increased risk of confusion, but also the potential for conflicting interests, particularly where macro-prudential objectives may be at odds with consumer or market objectives. Whilst such conflicts can still arise under the current structure, there are benefits to having them managed 'under one roof' and through one governance structure.

It is not clear from the consultation whether the proposals for coordination will be robust enough to address these risks. It may be appropriate for a more formal coordination panel to be established (for example), operating in a transparent way and bringing together the relevant interested regulatory bodies in sub-groups, dependent upon the international regulatory initiative. This would also allow for the participation of external international experts, where required and is likely to contribute to a more consistent approach to international regulation. .

References

[1] Kiff, J., S. Mennill, and G. Paulin (2010), "How the Canadian Housing Finance System Performed through the Credit Crisis", *The Journal of Structured Finance*, Fall 2010

[2] The Joint Forum (2010), "Review of the Differentiated Nature and Scope of Financial Regulation. Key Issues and Recommendations", January 2010

[3] Wong, E., Fong, T., Li, K., and H. Choi (2011), "Loan-to-Value Ratio as a Macro-Prudential Tool. Hong Kong's Experience and Cross-Country Evidence", Hong Kong Monetary Authority, Working Paper 01/2011, February 2011.

Background to Genworth Financial

Genworth Financial is a leading financial security company serving the lifestyle protection, retirement income, investment and mortgage insurance needs of more than 15 million customers, with operations in 25 countries.

In the UK, Genworth focuses on two product lines – Lifestyle Protection insurance for individual consumers and Mortgage Insurance for lenders. These products play a valuable role in providing long-term stability for borrowers and lenders and expanding sustainable homeownership.

Genworth's expertise gives a clear perspective on some of the most critical global economic trends, their impacts and how they might best be mitigated in the UK.

Genworth has embedded the FSA's principles of Treating Customers Fairly into all aspects of our business. We believe in providing customer choice and customer service. We are committed to transparency and furthering consumer education.

For more information please contact Gavin Hunt, European Mortgage Regulatory Specialist email gavin.hunt@genworth.com

To see more about our business, visit www.genworth.co.uk.

In response to this paper I would like to make a few comments which I have given below in response to questions 11, 12, 14, 21 and 31.

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

The strategic objectives for the FCA are fairly wide ranging and comprehensive.

However although the operational objectives are again wide ranging they must be backed up with more detail; particularly objective 2 in relation to consumer protection. At this stage it is unclear how the consumer credit regime will be controlled in the future but it is likely that it will come under the remit of the FCA. The focus of this consultation in relation to consumers is in the area of financial services. It should be noted that levels of consumer protection required differ depending on whether a service is being accessed or credit obtained and this should be carefully considered when finalising the objectives for the FCA. Consumers accessing credit are in a far more vulnerable position than those who are purchasing a financial service.

We welcome the acknowledgement that different consumers need different levels of protection depending on their circumstances and the product they are buying.

The regulatory principles of efficiency and proportionality are appropriate and necessary to ensure the effectiveness of the FCA, however the principle that "consumers are responsible for their own decisions" needs to be properly supported through other channels. The educating of consumers in relation to finance and financial products needs to be formalised and the most effective way of doing this would be to include it within the school curriculum. The educational materials currently available from various bodies including CFEB are not comprehensive and not as well publicised as they could be.

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

If the FCA is to take over control of the consumer credit regime consideration must be given as to whether this would be the most appropriate form of Governance for this sector. The control of the consumer credit regime should not be viewed as something that can be just added on to the control of financial services.

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**

We agree that transparency and disclosure can be a powerful regulatory tool when used appropriately. Disclosure is particularly helpful in ensuring consumer protection.

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

If the FCA is to become responsible for the consumer credit regime it will be particularly important to have a strong approved persons regime. It has been shown in the past that it has been possible for unfit persons to obtain consumer credit licences and recent improvements in the checks carried out on potential licence holders must be carried over to the new regulatory body.

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

We welcome the strengthened accountability.

Regards

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