Mark Hoban MP
Financial Secretary to the Treasury 20 April 2011
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Mark

FOS and regulatory reform

As trade associations representing a substantial share of the UK retail financial services industry, we believe that reform of the regulatory architecture should address the future role of the Financial Ombudsman Service (FOS).

We support the ongoing availability of an accessible, low-cost service for resolving individual disputes between consumers and firms. Therefore, we support the work of the FOS and believe that, in its role as an adjudicator of individual complaints, it has been generally effective.

However, challenges arise for the industry from ombudsmen decisions which appear to be inconsistent with regulatory expectations or market norms that were accepted at the time, and/or set precedents which have wider implications. On occasions, it has appeared the FOS is going beyond their core function and is seeking to set higher cross-industry standards, which is properly the function of the regulator, industry initiatives or competition.

Furthermore, uncertainty about how the FOS might respond to future classes of complaint, even where firms are in compliance with FSA regulations, can have an impact upon business decisions. For example, this is a real consideration for firms in deciding whether to invest in basic/simple advisory services, which could meet the needs of consumers who are currently unable to access the financial advice that they need (a problem which will be exacerbated by the Retail Distribution Review).

In recent years, these issues have been exacerbated by the growing influence of Claims Management Companies (CMCs) on financial services markets, which take advantage of the FOS processes, adding costs to the system, and creating something of a 'compensation culture' in the UK.

So we welcome your recent confirmation that the Government plans to reinforce the distinction between the roles of the Financial Conduct Authority (FCA) and the FOS, to give firms greater clarity and certainty. HM Treasury's recent consultation paper also stated the Government's commitment to enhancing the transparency and accountability of the FOS. The specific proposals in the consultation paper are a starting point in addressing these issues, but we suggest the legislation should go further and include the following:

- 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;

- 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;

- 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;

- 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;

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

- 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.

Each of us has responded individually to the consultation, but we thought it helpful to highlight the common ground on the need for change in relation to the FOS. We would of course be happy to discuss our thoughts with you in a meeting if you would find that useful.

Yours sincerely

Otto Thoresen
Director General
Association of British Insurers

Adrian Coles
Director General
Building Societies Association

Stephen Sklaroff
Director General
Finance and Leasing Association

Michael Coogan
Director General
Council of Mortgage Lenders

Martin Shaw
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3 April 2011

Financial Regulation Strategy
HM Treasury
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SW1A 2HQ

Dear Sir/Madam

I enclose a brief response to HM Government's consultation: *A new approach to financial regulation: building a stronger system* (CM 8012) of February 2011.

I hope that it will prove of some assistance.

Yours faithfully

R.J. Barry Jones

Response to HM Treasury's consultation document CM 8012 (of February 2011):

A new approach to financial regulation: building a stronger system

1. Most of the detailed, institutional proposals contained in the consultation document are appropriate to the proposed reform of financial regulation. It is not, however, self-evident that institutional failings lay at the heart of the financial crisis of 2007 to the present.

2. I engaged in consultations with both the Bank of England and the Financial Services Authority during the winter of 2001/2. The tripartite structure for financial oversight had recently been established and was informed by the international financial disorders of the last decade of the 20th century. As outlined by Bank of England and FSA staff, the new structure appeared to be fully fit for purpose and to be attuned to many of the dangers that were inherent in the financial system and, in particular, within the banking system.

3. The combination of recent experience with further reading on the disaster, and its sources, suggests, strongly, that the it reflects a widespread intellectual rather than a primarily institutional failure: the erroneous belief that a dynamic, and inherently unstable, financial industry could be managed effectively through 'light touch' regulation. The current consultation document signals a degree of recognition of this primary failure. The danger, however, is that this may be submerged, over time, by the elaborate institutional changes that are heralded by the document.

4. Effective reform of financial regulation has to rest upon a clear, and explicit, recognition that the financial system remains characterised by immanent dysfunction and imminent disaster: that the incentives for potentially dangerous ventures and innovations are so great that only the greatest level of active, official oversight offers any chance of avoiding future, and potentially catastrophic, disaster.

5. It is for such reasons that the proposal of a Proactive Intervention Framework (section. 3.33) is so welcome.

6. However, caveats within the wordage of the consultation document highlight the dangers of competing considerations and, hence, inconsistent and irresolute future action by the FPC and PRA. Thus, the caveat regarding the work of the FPC, within section 1.21, that:

> *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.* (p.7)

appears wholly sensible, at one level, but carries the real risk of challenge and/or confusion, at another.

There are similar dangers in the caveat in section 5.33 regarding the work of the PRA and the FCA to:

> ....*work together to ensure that the authorisation process does not present inappropriate disincentives for firms within to enter the financial sector.* (p.86)

7. These problems with the treatment of innovation within, and new entrants to, the financial services industry are compounded by the sparse attention in the consultation document that has been addressed to the emergence of para-banking entities (shadow-banks and the like), which may, in the opinion of some observers, pose as serious a challenge to future financial stability as any of the conventional banking enterprises.

8. Finally, the proposed membership of the interim FPC is wholly appropriate. The membership of two members who are strongly identified with warnings about the dysfunctions that have been inherent in the banking system in recent years – Adair Turner and Any Haldane – ensures that the committee will maintain a properly inquisitorial attitude towards financial developments, at least initially. It is vital, however, that the future membership of the FPC (and the PRA) embraces genuine diversity of outlook and those of genuinely sceptical attitudes towards developments within the financial industry (more Gillian Tetts and fewer financial industry grandees). Indeed, appointment to these two critical committees might seek to institutionalise one or more 'devil's advocates'.

R.J. Barry Jones

Emeritus Professor – the University of Reading

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14 April 2011

Dear Sirs

A new approach to financial regulation: building a stronger system

Background
Killik & Co was founded in 1989, to offer investment advice and trade execution services to the Private Client Stockbroking market. We currently operate from ten branch locations in the UK and one in Dubai, offering a range of financial services to our clients including traditional stockbroking advice, portfolio management, advice on CFDs and Spreadbets, Wills, and Trusts. We offer our own ISA and SIPP and have a separate Financial Planning arm called Killik Chartered Financial Planners, which holds prestigious Chartered Status and offers fully independent whole of market financial planning advice. We service approximately 20,000 clients and manage combined funds of £2.5 billion. We are members of the Association of Private Client Investment Managers and Stockbrokers (APCIMS).

Introduction
Thank you for the opportunity to respond to the Treasury consultation paper "A new approach to financial regulation: building a stronger system" ("CP"). This letter sets out our thoughts on a few key areas of the CP. We support the detailed response submitted by APCIMS on behalf of its members, therefore we have not provided our own response to each of the consultation questions.

Our response
We welcome the new approach to financial regulation outlined in the CP and the clarification that the Financial Conduct Authority (FCA) will be putting appropriate consumer outcomes at the centre of the regulatory process rather than it acting as a "consumer champion". We are also encouraged by the comments that "senior managers (and not regulators) are ultimately responsible for managing their firms in a way that is compliant with the regulatory framework". If this principle is adhered to, then the amount of rules could be significantly reduced, especially for those groups with a history of successful self-regulation. However, this needs to be supported by a strong regulator that is capable of removing those in the industry that undermine the good work of others and the confidence of consumers. Also, we have long held the view that consumer education is vital to improving consumer protection and hope that the Consumer Financial Education Body will be successful in this area. At the same time we support the principle that, "consumers of financial services are ultimately responsible for their own decisions". Sometimes it seems that this gets forgotten.

Overall, the proposals in the CP seem sensible. It is our belief that a proportionate approach is vital, as much of recent new regulation has adopted a "one size fits all" approach that does not take account of the actual risks posed by particular types of firm. Therefore we are encouraged by the statement at 4.9 that "proportionality will be crucial" in the FCA's work.

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A list of Partners is available on request.

We also believe that the FCA should face some accountability where regulatory failures do occur and that there should be a mechanism for investigating why such failures took place and learning the lessons from it. Of greater importance, however, is having sufficiently knowledgeable and experienced staff at the FCA and a supervisory approach that is capable of identifying likely points of failure before they arise. An unenviable task, but for firms whose business model is based on building close, long term relationships with clients and tailoring services to meet their needs, it is increasingly frustrating that we have to both pay for and suffer the dent in consumer confidence caused by firms who persistently fail to comply with existing rules. The ability of the FCA to be able to intervene and ban products (a topic currently under consideration within the Financial Services Authority's document "DP11/01 Product Intervention") may be a powerful new tool in this area. Such powers will of course need to be applied proportionately with the full consequences of doing so clearly thought through beforehand.

With regards to the proposals for disclosure that a Warning Notice has been issued against a firm before a full investigation and conclusion on the firm's conduct has been reached, we believe this should be approached with caution. Such action would immediately damage a firm's reputation and cause concern and anxiety to its clients. If, following investigation there is found to be no wrongdoing, the damage will already have been done and in the eyes of many the "no smoke without fire" adage will mean that reputation will be extremely difficult to recover. We would urge that this particular proposal is reconsidered.

We hope that you will consider our comments and the detailed response from APCIMS as you further develop the new regulatory framework. If you would like to discuss any of the points we have raised in more detail, please feel free to contact me.

Yours faithfully

Penny Rooney
Compliance Director

KPMG

HM Treasury

A new approach to financial regulation: building a stronger system

The 'twin peaks' approach to regulation will not in itself build a stronger financial system without greater certainty around the new authorities' scope and powers, clearer supervisory coordination arrangements and a more definitive engagement and leadership in Europe.

Overall comments

Reforming the regulation and supervision of financial firms is one of the core responses to the financial crisis currently being delivered through national commitments to the G20 agenda. Significant change in the organisation of global supervision is underway so proposed changes to the UK structure should be seen within this context.

The overhaul of UK supervision was well trailed by the Conservative party whilst it was in opposition. Concerns previously expressed with proposals have in part been addressed with changes to the new „Financial Conduct Authority" and greater recognition of the importance of competition However there remain some significant challenges which require further consideration. The most important of these are:

- Taking adequate account of threats to financial stability that arise from outside the financial sector, such as loose monetary policy. Both the FPC itself and the prospective macroprudential toolkit focus too narrowly on threats to financial stability from within the financial sector.
- Defining more clearly what constitutes an "optimal" degree of financial stability, recognising that beyond some point the benefits of greater financial stability are more than offset by the negative impact on economic growth.
- Defining more clearly what constitutes appropriate consumer protection, since some types of more intrusive regulation can diminish the extent to which consumers take responsibility for their own actions and the extent to which consumers make adequate provision for savings, investment and protection.
- Ensuring that there is effective coordination and cooperation among the PRA, FCA and FPC. This will not happen automatically just because memoranda of understanding are in place.
- There remains significant scope to develop how the UK"s twin peaks approach will fit with the new European Supervisory Authorities. This will become increasingly important as more rule-making powers sit within the EU. The UK"s leadership in EU financial reforms should be a key consideration.

The Bank of England (BoE) will need its extended powers and tools to fulfil the new financial stability responsibilities, and putting the regulation of settlement systems and central counterparty clearing-houses alongside payment system oversight makes sense. A strengthened prudential role should go a long way to ensuring greater rigour and challenge on capital and liquidity levels and so strengthen confidence in markets.

New conduct tools such as the updated Section 404 consumer redress proposals will

give the FCA strong powers around consumer detriment concerns. What is surprising is continued uncertainty around the scope and reach of the Financial Ombudsman Service (FOS) as it remains independent from the FCA.

Specific areas of comment

We have provided what we hope are some helpful overall comments and where we believe we can contribute insight have also responded to specific consultation questions.

Bank of England and Financial Policy Committee (FPC)

The FPC will have responsibility for considering macro-prudential and systemic issues that may threaten financial stability. Before answering the specific consultation questions we have highlighted some fundamental questions concerning financial stability have not been fully addressed and offer suggestions on how these could be addressed.

How will the other potential causes of financial stability beyond the financial sector be addressed?

The new arrangements for financial regulation could clarify how other potential threats to financial stability such as monetary and fiscal policy could be assessed and mitigated, and what arrangements would be put in place if financial instability emerged.

The remit of the FPC has potentially an overly narrow definition of financial stability, focusing only on risks within the financial system. However it is not clear who is supposed to be assessing and addressing the risks to financial stability arising from outside the financial system from say loose monetary policy. Even if the FPC was able to assess these threats to financial stability it is not clear that it has the appropriate tools to mitigate them.

It also remains unclear what the role of the FPC would be if financial instability did emerge, since at that point there might conceivably be a need to use public funds to resolve the situation, so the Treasury would also have to be involved or indeed in charge before that point.

Will there be greater clarity on what stability means?

Consideration could be given to developing and publishing a set of metrics for financial stability and in particular for assessing emerging threats to financial stability.

It is not entirely clear what the financial stability objective means in terms of deliverable outcomes, and what success would look like. There is no uniformly accepted definition of what financial stability is but most definitions focus on the stable provision of financial services. The Bank of England defines financial stability as "*Maintaining a stable provision of financial services to the wider economy - payment services, credit supply, and insurance against risk*", but this does not easily translate into clear measures of success, and nothing as quantifiable as say an inflation target.

Who will determine the 'tipping point' between financial stability and economic growth?

The proposed discretionary powers for Government to provide the FPC with a "remit" could be used to address explicitly the trade-off between financial stability and economic growth, specifying how the FPC should take account of this trade-off.

Where the risks to financial stability are high, taking decisive action that reduces the impact of a financial crisis on the real

economy is clearly important. However, it does not then follow that all actions on financial stability will be welfare-increasing, if for instance they reduce innovation and limit economic growth.

A fine balancing act to deliver neither too little nor too much financial stability will be needed. However clarity is needed on who will be determining this "tipping point" - is it the FPC, or the Government? Without clarity on this trade-off there is a risk of too much focus on financial stability, and not enough on sustainable economic growth. The requirement for the FPC to not generate "a significant adverse effect on economic growth" may need strengthening as it does not in itself provide an answer to where this "tipping point" might be.

What will be the mechanism to decide the trade-off between monetary and macroeconomic policy?

The Government‟s defined "remit" could also cover the potential trade-off between monetary and macroeconomic policy. Legislative and institutional arrangements specifying that the Government can issue a supplementary remit when a significant trade-off between the two objectives emerges needs to be drawn.

There is perhaps too little appreciation that in practice macroprudential tools are closely related to monetary policy, and vice versa. Macroprudential tools are much like the historic use of credit controls, restricting the availability and/or raising the price of credit. An important two-way relationship exists, as demonstrated in the run up to the crisis when loose monetary policy in the US (and, arguably, in the UK) contributed to financial instability.

This means it will not always be possible to meet both policy objectives and a choice will have to be made about the trade-off between the two objectives. It remains unclear how any such trade-off will be assessed and managed in practice.

Responses to specific consultation questions:

Macroprudential tools - Q1 and Q2

There is no shortage of potential macroprudential instruments, but it is important to recognise that very little is known about the impact they will have on financial stability, on economic growth, and on the transmission mechanism of monetary policy.

Role, governance and accountability of FPC - Q3

There is a need to specify the role of the FPC in relation to (i) the wider sources of risks to financial stability, and (ii) situations when financial instability emerges and consideration is given to exercising the powers of the resolution authorities.

It will be very challenging to hold the FPC accountable in the absence of (a) any clear measures of the risks to financial stability, (b) any clear specification of how the FPC should deal with the trade-off between financial stability and economic growth, (c) any clear specification of how the Bank of England should deal with conflicts between its two objectives; and (d) any clarification of the role of the FPC in identifying and mitigating risks to financial stability that are outside its control.

However, if it is possible to establish some clearer targets for financial stability and to define more clearly the trade-off that the FPC should accept between financial stability and economic growth, then a similar accountability could apply to financial stability as to monetary stability. The overlap between the instruments available to the FPC and MPC to achieve the two

objectives also points to the same conclusion.

This implies the equivalent for financial stability to the MPC Inflation Report, publishing the minutes of the FPC including the “votes” for policy change, letters of explanation to the Chancellor of the Exchequer if targets for financial stability are either overshot or undershot, and appearances before the Treasury Select Committee.

There will also be considerable benefits to accountability if the FPC is required to undertake and publish cost benefit analysis benefits when it either recommends or takes direct action itself to use macroprudential tools.

Systemic infrastructure - Q4

It is not clear how far the proposals address the question of the systemic importance of clearing systems as a new source of potential instability once large volumes of (currently OTC) derivatives are cleared through them.

Prudential Regulatory Authority (PRA)

The main emphasis of the PRA appears to be on financial stability but with little reference to depositor and policyholder protection. With regards to insurers it is unclear what the PRA"s supervisory approach will be - it has separately been suggested that the emphasis will be on the “reasonable expectations” of with-profits policyholders, implying some overlap with the FCA, this would benefit from being clarified.

Proposals state the PRA will establish a “proactive intervention framework”, but there is no detail on how this would operate, and how it would link to the recovery and resolution plans of systemically important financial institutions (SIFIs) being worked on internationally.

Responses to specific consultation questions:

Objectives of the PRA - Q5

With such a strong focus on financial stability rather than depositor, policyholder and investor protection there is a risk that the PRA devotes all its attention on institutions and sectors regarded as being of systemic importance. It is less clear how the PRA will regard the insurance sector and smaller deposit-takers and lenders.

Scope of the PRA - Q6

The key issue here is the effective cooperation and collaboration between the PRA and the FCA, rather than the precise dividing line of responsibilities between the two organisations.

Judgement-led approach - Q7

There can be considerable confusion about the actual meaning of terms such as “*judgement-led*”, “*principles-based*” and “*outcome-focused*”, so more specific definitions would be advisable to avoid unintended consequences. Currently it is not clear how the PRA will ensure that its „judgements" do not reflect an overly risk-averse approach motivated by avoiding criticism should a failure or financial instability occur (see also response to Q9).

Governance framework - Q8

Although the proposed division of roles of the Board of the PRA and of Court are reasonably clear there remains scope for conflicts to arise – for example, if the Board of the PRA establishes a strategy and approach for the PRA for which the Court is not prepared to provide an adequate level of resources. It is also not clear how conflicts of

interest will be avoided it the non-executive members of the Board of the PRA become more involved in regulatory decisions about individual financial institutions.

Accountability - Q9

Although understandable, the requirement on the PRA to make a report to the Treasury in the event of a significant regulatory failure does carry the risk that regulation and supervision will be driven by risk-aversion on the part of the PRA. The same point is relevant to the FCA (see Q12).

Engagement mechanisms - Q10

An unhelpful distinction can sometimes be drawn between „prudential" and „consumer" issues. Prudential regulation is of considerable importance to consumers not least in the case of an institution becoming insolvent or illiquid making it difficult to pay depositors or policyholders the funds owing to them. A good reason for introducing a Consumer Panel for the PRA would be to ensure that the PRA remained focused on this important consumer protection issue.

Financial Conduct Authority (FCA)

The proposed objectives of the FCA still require some clarification before coming into legislation, in particular:

- The strategic objective of the FCA is to "protect and enhance confidence in the UK financial system", while the explicit protection of consumers appears only as an "operational objective".
- It is not entirely clear what is meant by the FCA being directed to "*discharge its general functions in a way which promotes competition*". Some additional clarity on what this will mean in practice would be helpful. We also note here the recommendation of the Independent Commission on Banking that the FCA should be given a clear primary duty to promote competition.
- Crucially for wider public policy concerns there is no operational objective to take account of whether consumers are making proper provision for savings, investment and protection – so there is a risk that the FCA will place more emphasis on "protecting" consumers by restricting the products and services available to them, rather than looking for ways to encourage consumers to make proper provision for their current and future needs.

The proposals reiterate recent FSA discussions for extended powers on "product intervention". It is also proposed that the FCA should be more willing to demand that firms provide redress to consumers, and be given stronger powers to ban misleading financial promotions and to publish the fact that it has done so. This marks a significant shift and risks moves to a tick-box approach to product suitability, with the potential to reduce the availability and innovation of products and services.

The core role of the FOS to intervene on individual cases is appropriate and widely supported. However when a theme emerges – either around a specific firm or a specific product, a formal mediation should be put in place to achieve an overall balanced settlement. Equally where a firm wants to resolve a cohort of cases there should be a process that provides quick resolution. It isn"t clear that the proposed increased 404 powers would be helpful in this sort of mediated approach.

Responses to specific consultation questions:

FCA objectives and principles - Q11

The proposed operational objectives of the FCA are rather vague, for example the phrase "*an appropriate degree of protection*

for consumers". If the objective is to be this general more could be helpfully said about the mechanisms which will establish what counts as "appropriate".

There would be considerable benefit in giving the FCA either an objective or a regulatory principle to take account of the impact of its actions on the adequacy of the saving, investment and protection bought by consumers. Otherwise there is a danger that the FCA adopts an approach where consumer detriment is seen only as something that arises from buying unsuitable products, rather than from being unable or unwilling to buy suitable financial products at all.

The principle that "*consumers are responsible for their decisions*" appears to be somewhat inconsistent with the direction of the FSA"s recent emphasis on product intervention and its moves away from „appropriate and transparent information" (as described in paragraph 4.8). It is not clear how the FCA will work within this apparent inconsistency.

FCA governance and accountability – Q12

The same points are relevant for the FCA as were raised about the PRA in answer to Q9 above.

Product intervention - Q13

As already covered we feel there is a risk that the FCA could strike a wrong balance between two different types of consumer detriment. Preventing consumers from buying an unsuitable product could also result in consumers saving, investing and protecting themselves much less. This trade-off, and the role of the FCA in taking due account of it, could helpfully be made more explicit.

FCA powers - Q14

Strengthened enforcement powers including the publication of draft enforcement notices could give rise to considerable concerns about the consequences on individuals and firms. Recent experience demonstrates the significant impacts an announcement that doesn"t ultimately result in enforcement can have. Furthermore there is often a benefit to both parties of a open debate on concerns which may end if a more litigious relationship evolves.

Competition - Q15

Both the PRA and the FCA could benefit from at least having to take account of the impact of their regulatory requirements on competition. There is could be concerns that inappropriate trade-offs will be made if there is no explicit requirement on the PRA and FCA at least to take account of competition.

Regulatory process and coordination

The UK"s voice in Europe is one area where much greater clarity on coordination is critical.

Currently proposed is that the FCA will face off to the European Securities and Markets Authority (ESMA) and the PRA to the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA). There is potential for some confusing crossovers, for example where a bank (subject to PRA supervision) also runs what is deemed under the new MIFID 2 definitions to be an Organised Trading Facility (presumably subject to FCA supervision), potentially requiring a „lead regulator" with each regulating the parts most relevant to them.

With so much financial rule-making power now within the EU it will be vital that the UK"s insights and interests are strongly

represented through a well coordinated and alignment.

Responses to specific consultation questions:

Effective coordination - Q17

Mechanisms to enhance cooperation and coordination between the FCA and the PRA are to be welcomed. However some clarity would be helpful on arrangements to trigger a review or appeal when firms believe that cooperation or coordination is not operating effectively. This could happen for instance if the FCA and PRA take different views on actions around corporate governance and internal systems and controls.

PRA veto - Q18

The case supporting why financial stability concerns would always be more important than consumer protection interests would benefit from further explanation as it is difficult to assess situations where FCA actions could impact financial stability in practice. Consideration might also be given as to why this power of veto would only be for FCA actions, rather than say actions decided on by a court or by the FOS.

Regulatory processes - Q19-21

Some of the overlapping interests of the FCA and the PRA in these areas of authorisation and approved persons mean that any system might be prone to inefficiency. More thought could be given to these arrangements, which could potentially be costly and confusing. Whilst understandably single points of contact might be against the spirit of twin peak regulators, some form of a shared service that handles applications and other administrative matters might be beneficial to all involved.

Passporting - Q22

Coordination and interactions within Europe will be vital and so as consistent approach to EU processes would be desireable.

Mutuals - Q23

Inevitably much of the focus of this change has been on larger firms, however diversity, competition and choice offered by other organisational types will be important measures against which the new structures success will ultimately be judged.

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Key contacts

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A New Approach to Financial Regulation: Building a Stronger System

Response from Legal & General
April 2011

Legal & General Group Plc

Legal & General Group is one of the UK's largest financial services groups. We are a leading provider of risk, savings and investment management products in the UK, with £345 billion of assets under management, more than seven million customers and over 8,000 employees worldwide. Legal & General welcomes the opportunity to respond to '*A New Approach to Financial Regulation: Building a Stronger System'.* Our response follows our earlier submission on '*A New Approach to Financial Regulation: Judgement, Focus and Stability'* in September 2010.

Executive Summary

We are encouraged that this Consultation addresses many of the issues we raised in our response to the previous consultation on the proposed new regulatory arrangements. In particular, we are pleased by the recognition that the business models of insurance companies differ to those of banks.

Despite this, '*Building a Stronger System'* remains very bank-focussed. For example, non-executive directors of the proposed bodies, including the four independent members of the interim FPC, appear to be drawn almost entirely from banking or central banking environments. More substantively, the paper fails to address the real and serious differences between the proposed approach to macro-prudential regulation of banks – which we broadly support as having potential to deliver positive policy outcomes – and the current parallel proposals for insurance companies under Solvency II, which paradoxically produce almost diametrically opposite results (see our responses to Questions 1 and 2).

'Building a Stronger System' discusses the interplay between EU and UK regulation, another point we raised in our earlier response. We agree absolutely with the importance of ensuring that the UK's interests are best represented in international forums. However, in reality, under the Omnibus 2 Directive regulatory power will pass from local regulators to EIOPA, ESMA and the EBA. We are already seeing this happening, even before the passage of Omnibus 2, for example through the imposition on the UK insurance industry of unnecessary and badly-devised EIOPA stress tests. The discussion of balancing UK and international regulatory influence in '*Building a Stronger System'* is at best aspirational, and at worst meaningless if HMG and the UK regulators have ceded powers to the EU regulatory bodies even before they have been established in law. In order to retain their influence in this environment, the UK authorities will have to do more to influence the process of setting EU rules: a good start would be to push back on multi-jurisdictional stress-testing which merely risks damaging market and consumer confidence with no corresponding benefits.

We welcome many of the proposed objectives and principles for the PRA and the FCA, particularly those for the PRA that relate to competitiveness and the importance of a stable regulatory system in maintaining the UK's position as a world-leading financial centre and the recognition that consumers should retain some responsibility for their own decisions. We are pleased this will be reflected in the FCA objectives, and believe this organising thought should be applied to all regulatory agencies including the Financial Ombudsman Service (FOS).

Turning to the FCA, we welcome the fact that the Government has noted the widespread industry concern that describing the FCA as a 'consumer champion' would undermine its credibility and impartiality as a regulator. However, we remain concerned that the proposed legislation does not address the governance and accountability of hanging organisations such as the Money Advice Service or FOS. We are particularly disappointed that the Government has not used this reform of regulation to make a clear determination over the role of FOS. Currently, FOS decisions are de facto policy decisions, which only have to take account of, not follow, law and regulation. It is against all notions of good regulation and rule of law principles for policy precedents to be set without having to follow regulation and law and it is vital that the FOS is held to be accountable for its actions. Appropriate engagement on this issue by government is required.

We feel that some of the proposals lack detail, particularly the series of Memoranda of Understanding (MoUs) and co-ordination mechanisms that are designed to deal with the overlaps, regulatory duplication, underlap and conflicting regulatory approaches that the new structure will have. The lack of detail on these points and their existence outside primary legislation will mean that both industry and consumers will be denied the opportunity to comment and feed in to such matters. We also have some practical concerns arising from the apparent assumption that duplication and inefficiencies can be 'co-ordinated away'. We feel that this may be more difficult in practice.

It is equally not clear how the PRA and the FCA will reconcile conflicting issues. Effective coordination between the proposed new authorities will be critical but the current proposals may prove awkward to implement in practice. Close co-ordination between the authorities have to be embedded at a working level across all the authorities and cannot be limited to high-level co-ordination at board level. While we welcome the Government's proposals to introduce a statutory duty of co-ordination, it is important that authorities are open and transparent when implementing these.

We share the Treasury Select Committee's concerns regarding the use of judgement-led regulation where this is not supported by a strong set of principles, as we feel that discretionary supervision can lack accountability. We would also highlight the fact that the allocation of powers to the FCA to ban products and intervene in the product lifecycle pre-empts the outcome of the FSA's current consultation on its discussion paper '*Product Intervention*'. This throws into question the consultation process on the issue and indicates that practitioner views are unlikely to have a material effect on what is proposed.

We are similarly concerned that the proposed power for the FCA to publish details of the commencement of enforcement proceedings could inflict costly reputational damage to individuals and firms before the allegations made by the investigators are fully tested. This is wrong in principle and risks undermining confidence in financial services. There will be a need for clear due process and opportunities for appeal before these proposals are finalised if the rule of law is to be met.

We welcome the decision that the UKLA will remain part of the FCA, a point made by ourselves and many other respondents in response to the previous paper. However, we are concerned that the extension of the FCA's statutory objectives to the listing regime ignores that the UKLA has the very different focus of market transparency and competition distinct from the other functions of the FCA. The proposal to extend the skilled person report to the UKLA's powers is an increase in powers not justified by any failure in the listed markets regime and will add to the regulatory burden and cost of being listed in the UK.

Finally, on next steps of the reform process, we agree with the Treasury Select Committee, that it is crucial that the Government take the time during the pre-legislative phase to receive expert input so as to ensure the effectiveness of legislation and the ultimate ability of the new institutions to provide appropriate prudential and conduct regulation.

Consultation Questions

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

As previously stated, the consultation is overwhelmingly bank-focused. In that context, the macro-prudential tools discussed are in our view helpful, in that they are likely to bring greater stability to the banking sector as and when required, and to act as counter-cyclical risk-dampeners. The boxed section below offers comments on the specific macro-prudential tools discussed, but we would raise three broad preliminary points:

- First, many of the macro-prudential tools described from paragraph 2.46 onwards are untested and are still being developed. As such, we believe that the FPC must undertake rigorous analysis of the impacts and effectiveness of these tools before it makes any use of these mechanisms. We would also question whether this leaves scope for further unpublished tools to be introduced without consultation in draft legislation.

- Secondly, we feel that the manner in which the 'levers' are used will be just as important as the design of the tool itself. It is critical that they are used in an appropriate manner by the authorities, and that they respond as far as possible to the development of market bubbles or crunches and changes in risk premia that clearly go beyond straightforward objective responses to changing perceptions of underlying asset values.

- Thirdly, we support the Government's view that macro-prudential measures are likely to be more effective if the broad framework for their use is developed internationally and that an important aim of macro-prudential policy is to achieve international consistency and a level playing field.

We also believe there is a case for the regulator to consider whether variants on these banking-sector tools would be worthwhile for the insurance sector. These would need to be different because, as recognised elsewhere in the paper, insurers are not 'systemic' in the same way as banks: they do not present liquidity risk, they do not in relative terms use leverage, they have very different business models and engage in different activities to banks on a different business cycle.

Paradoxically, however, many of the principles of macro-prudential risk management identified in the Consultation – and which we strongly support – <u>do</u> have a direct application for the insurance sector. Notably these include counter-cyclicality, an appropriate balance between national discretion and EU co-ordination and an internationally level playing field. However, we are concerned that these (entirely appropriate and worthwhile) objectives will be very difficult to achieve for insurers given that the new Solvency II capital regime as currently envisaged risks creating excessive, volatile and procyclical capital requirements. Solvency II gives very little discretion if any to the UK domestic regulator, and will only apply to EU insurers, and thus risks failing to achieve the objectives of national/EU regulator balance and global 'level-playing field'.

For example, we agree with the premise in paragraphs 2.46 and 2.47 that *'...it will be important for the UK authorities to continue to make the case for the right balance between EU coordination and national discretion in EU macro-prudential policy'*. However, Solvency II will seriously diminish the ability of the UK to exercise discretion in its domestic operation of the macro-prudential framework due to the prescriptive nature of the level 2 and 3 regulations and their application by EIOPA. The importance of national discretion is also paramount in the application of stress-tests – currently a live issue – where it has been disappointing to see that EIOPA has enforced inappropriate methodologies based on as yet unagreed regulations

on the UK insurance industry. This must not be allowed to happen in the future. We believe our view is widely shared by the insurance industry in the UK and in other member states.

In short, we are concerned that the sensible arrangements for banks set out here may result in far less onerous treatment for banks than that which is envisaged for insurers under Solvency II: a manifestly perverse result given the relative risk profiles (and recent histories) of the two sectors.

Where the Consultation (section 2.72) refers to ad hoc tools, we feel it is particularly important for the UK insurance industry that these should include the ability, reserved to the national regulator, to base capital regulation on a market-referenced rather than a purely market-consistent approach, especially for longer-dated assets and liabilities where there is no deep and liquid market, the ability to make adjustments to calibrations where this prevents an unfair or perverse result, and the ability to decline supranational regulators' requests for stress tests which are deemed unreasonable.

Facilitating appropriate treatment for insurers in this way should be important to the FPC, not least because while, as noted above, insurers are not 'systemic' in the same way as banks, they are linked to them as providers of capital and liquidity and are integral to the smooth functioning of the financial system as a whole.

Macro-Prudential Tools

Counter-cyclical capital buffer (2.52) - we agree with the proposal that (for banks) '*…during a downturn, these buffers would be withdrawn, enabling banks to reduce their capital ratios'*. The same facility needs to be put in place for insurers, as this is exactly the opposite of the current procyclical character of the Solvency II requirements.
Reciprocity (2.52) - we support this principle: reciprocity '*promotes a level playing field between domestic and foreign banks*'. The same arrangements need to apply for insurers: current Solvency II equivalence proposals, would by contrast advantage non-EEA players. A European insurer operating in the United States will be disadvantaged against its domestic competitors, as it will be subject to EU capital rules.
Variable risk weights (2.53) - we feel that this instrument could have an unintended knock-on effect for sterling corporate markets. We would note that unlike these proposals, Solvency II presents zero-liquidity risk for EU government debt. We would also question how variable risk weights be applied internationally – there is again a risk of an unlevel playing field.
Liquidity tools (2.55) – we agree with these proposals, as insurers are very substantial providers of liquidity in the market and this should not be jeopardised. However, we also agree that '*further analysis is needed to achieve greater clarity on their potential effects*'. This will become increasingly important as Quantitative Easing is withdrawn and greater reliance is placed on market providers of liquidity including insurers.
Forward looking loss provisions (2.58) – we agree with the proposals which mirror the insurance industry's reserving approach to credit default risk under the current Solvency I capital rules. For insurers, this approach would reflect the risks of holding credit than the current mark to market valuation approach under Solvency II.
Stress tests (2.70) – we agree that stress tests offer a useful tool for regulators to access systemic financial strength. However we believe strongly that Regulators must set stress tests with reference to current solvency regulations; ad hoc stress test requests could pose a threat to financial stability.
Ad-hoc tools created for specific circumstances (2.72) – we note the importance of considering the 'unintended consequences' of the PRA or FCA's actions. However, as noted above we would question how much discretion these regulatory bodies will have due to the significant role played by EIOPA. Testing will be critical.

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

These proposals fall short of addressing the concerns of both the Treasury Select Committee (TSC) and industry. It is essential that the Government gives a detailed view of what the financial stability 'target' should be, how it should be assessed, and how any trade-offs between stability and growth are to be managed. These issues have not been addressed in the consultation and uncertainties on these points remain.

Further the TSC raised concerns that the appointment of the external members of the FPC should ensure that there was no room for accusations that it is '*overly focused on banking nor that it lacks the expertise to look at important sectors, such as insurance*'. We strongly agree and do not believe that the Government's appointments of Alistair Clarke, Michael Cohrs, Donald Kohn and Sir Richard Lambert as the only external members of the interim FPC address these concerns, as the expertise of these four individuals is heavily centred on macro-economics and banking. We would be interested to know what measures are or have been taken to ensure that these members are up to date with and have relevant expertise in the wider financial services sector. Detailed proposals on the proposed powers for the FPC to issue recommendations to and direct the PRA and FCA, including the comply or explain regime, will be critical in the pre-legislative phase to enable firms to understand the basis of co-ordination between the FPC and supervisory bodies.

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

We support the close involvement of the Bank of England in the regulation of systemically important infrastructure including settlement and payment systems and RCHs. It is essential that the Bank's regulation of this infrastructure is in close co-operation with the FCA given its responsibilities as regulator of the wholesale markets. We feel that a duty to consult with the FCA and share relevant information needs to be clearly referenced in the legislation.

We are interested in the ideas set out in 2.133 and 2.134. On the one hand we are concerned by the suggestion that 'future proofing' may in effect mean gold-plating future EU regulations, while on the other there is a suggestion of reserve powers permitting a derogation from EU-wide rules. We would be interested in exploring the feasibility of the latter part of this approach under EU law, and if indeed it is feasible, why it is being reserved for issues concerned with important but essentially ancillary functions which support markets and not being applied more widely.

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

We are broadly supportive of the objectives and principles proposed for the PRA, although we would also welcome clarification of the legal force of the objectives and principles set out here, in particular their position vis-à-vis EU law, particularly where EU directives are directly enforced by regulation (i.e. with no intervening UK legislation). Both the PRA and the FCA should, at the very least, include a regulatory principle to have regard to the European and international regulatory environment, and to avoid creating regulatory inefficiencies, or worse inconsistencies, and competitive disadvantages for UK firms through pre-emptive regulation.

As we stated in our previous response, we support objectives for the PRA and FCA designed to facilitate a competitive economy brought about by a fair and stable regulatory environment. This is essential in order to maintain London's position as a world-leading financial services centre, but it is not just an argument about London: the importance of the UK insurance industry as an employer extends far beyond London, and it manages investments amounting to 24% of the UK's net worth and employs 275,000 people nationwide.

We have reservations about the fifth principle which covers *'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'. We feel that this power, as a means of contributing to the regulator's strategic and operational objectives, is too widely drawn. In light of potential reputational damage, we feel that greater checks and balances are required.

However, while we feel (with the exception covered in the previous paragraph) that the regulatory principles given are unarguable, we are not clear how they will be applied in practice. For example, it is a 'principle' that regulators make information available but what force does such a principle have? Regulators must take account of them when regulating, but can this override restrictions of confidentiality of information provided by firms? Is the intention to back up the principle with hard rules/requirements on firms to disclose or will changes sweep away existing confidentiality provisions? To give another example, principle three in box 3.B states that consumers should take responsibility for their decisions; while the PRA and FPC may take this on board, the principle will be diminished if FOS does not also take this into consideration. We appreciate that it is not possible to cover every detail in this very wide-ranging Consultation, but these practical issues serve to illustrate the need for very full pre-legislative scrutiny before these principles are put into practice.

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?

As in our previous response, we believe it is appropriate that insurance firms should be within the scope of the PRA. We feel however that there is not enough clarity or opportunity for input regarding how the PRA and the FCA will reconcile conflicting issues of policyholder protection and the expectation of future return and balance sheet soundness.

We would also like more clarity as to how dual-regulation will minimise the regulatory burden. For example, will multiple-supervision affect the number of ARROW visits that firms receive? We have previously suggested that it may be appropriate for PRA to delegate certain activities to the FCA where they do not relate to systemic risk, and we urge that this approach be considered as a potential way to avoid duplication of functions between the two agencies.

We do not have a developed view on the inclusion of Lloyds within the ambit of the PRA, and believe this is essentially a matter for Lloyds and HM Treasury.

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

Regulators do not have a monopoly on good judgement, and while judgement has a clear role in the exercise of regulation, we are concerned about the principle of judgement-led regulation. We consider it important that the correct combination of judgement and rule-based regulation is applied, and that judgement is based on rigorous application of facts and relevant experience, and exercised at an appropriately senior level within the context of the rule of law and proper procedure. In practice, this means that there must be appropriate oversight of judgement-led decisions and that these will be taken by more senior, experienced staff.

It is especially important that the international and EU dimensions of judgement-led regulation are properly covered. UK regulators will need to exercise judgement, but this is very different from handing unfettered discretion to EU bodies such (as EIOPA) which have primacy in the event of a dispute with local regulators. We believe that the authorities will need to consult further on how they intend to operate the PRA regime in a manner that is both consistent with EU requirements and the proposed judgement-led approach.

In particular we feel that the wording of the section of the legislative framework which states that the PRA will require compliance with the 'spirit' of the rules permits far too much subjectivity. A judgement-led process can cover a range of approaches, from challenging a company about how it would perform under a variety of market conditions, to substitution of the regulator's judgement for that of the company's management. With such an approach the aim should be to ensure that companies can fail without undue adverse impact, rather than attempt to second-guess management approaches.

The TSC expressed concern about the use of this approach without strong principles around it and was particularly concerned about how the PRA will manage situations in which members of the board of a supervised firm, who have personal legal responsibilities, do not agree with its judgement. This issue has not been addressed in the paper.

In a world of judgement-led regulation, particularly if there are limited procedural safeguards, consideration should be given to the indemnity of those making such judgement-led decisions. Is this still practicable given that such decisions may be made subjectively? Where such judgements lead to unnecessary loss to industry or consumers, should there an appropriate route to redress? These questions still need to be answered.

Further clarification as to why the PRA should have a different appeals process from the current FSA process would also be welcomed. We are not convinced that avenues of appeal should be diluted for the PRA. Indeed, given the wider scope for poor decision-making, it is arguable that they should be enhanced from present provisions. We also share some of the concerns of the TSC regarding the accountability of the Bank of England, especially regarding the rule of law and due process.

Finally, paragraph 3.35 does not provide adequate detail on the intended structure and operation of the Proactive Intervention Framework (PIF). By stating that the application of the PIF will be 'tailored' to different types of firms and sectors, the paper suggests that the PRA will apply a graduated focus, with more intensive supervision being used for medium to high impact firms. However, this again fails to address the specific concerns of the TSC which believes, given that Northern Rock was 'a low impact' firm, that the Government will need to have a strong justification for reducing the supervisory effort of the PRA for 'low-impact' firms.

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

We are fully supportive of making the PRA part of the Bank of England group, and feel that the re-establishment of the link between the Bank of England's financial stability functions and the prudential regulation of financial services is a positive step. However, we feel that the wording of this section regarding how the new architecture needs to be underpinned by 'suitable checks and balances' lacks necessary detail and we would like more clarity as to what these checks and balances may entail.

We are also pleased that the PRA's operational independence will be supported by an independent board with a majority of non-executives. However, given the recent appointments to the interim FPC, we feel that this board should be reflective of the financial system as a whole, and so we would like clarity as to how many of these non-executives will come from a non-banking background.

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

We would like to know what the requirement is for the PRA to set out reasons for its decisions. There is an issue of moral hazard here; it seems that the PRA is not accountable for its actions as it is unclear whether there are any sanctions if it makes a wrong decision. It is important that accountability is applied both to the process by which decisions are taken and by the substance of those decisions.

We fully support the measure that where there is significant regulatory failure, the PRA must make a report to the Treasury, which will then lay the report before Parliament. However, paragraph 3.53 which sets out the TSC's primary role in holding the PRA to account is inadequate, as while they have the power to 'name and shame', the TSC do not have the power to intervene or retrospectively punish the PRA if they fail in their duties.

We are also unclear as to how the PRA will '*maintain a system for the investigation of complaints*', and we would like more clarity about how the PRA will ensure the transparency of the complaints process. The consultation sets out the current complaints system for the FSA but does not actually state whether this is the complaints procedure which will also apply to the PRA, other than to note that an external scrutiny of complaints will take place. We cannot therefore comment on the full accountability mechanisms as much uncertainty remains. Basic questions such as whether regulated firms are able to use the complaints procedure, and if they are how would this work in practice if complaints are judgement-led remain.

We would note that the FSA's existing complaints system tends to be used by individuals and small firms for relatively trivial or non-systemic matters. The move to a more judgement-based approach requires a swifter appeals process for more substantive issues. The Consultation does not particularly comment on the Upper Tribunal, but while we believe this needs to be preserved, its court-like approach means decisions can be slow.

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

We are happy with the proposed mechanisms but feel that the real test of engagement will be the PRA's appetite for meaningful and substantive industry consultation.

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

We strongly welcome the fact that the Government has acted on the widespread industry concern that designating the regulator as a 'consumer champion' would undermine the impartiality and credibility of the regulator in its dealings with firms.

Similarly we support the principle behind the first operational objective and agree that competitive markets deliver better outcomes for consumers. While we agree that the FCA can and should take action in respect of competition, we would like more detail as to how the Government intends the FCA to deliver its objective to have regard for competition both '*broadly, and in pursuit of any of its operational objectives'*. Is it expected that the FCA will proactively investigate uncompetitive behaviour or seek to take action against over-dominant providers? If so how would this relate to other competition regulators such as the OFT? It would also be helpful if it was clear that the FCA should have regard to not just competitiveness within the UK market, but also the international competitiveness of the UK financial services sector – thereby, for example, providing an incentive not to gold-plate Directives.

We feel that there is a gap in the wording of the second objective, which states that '*the Government does not believe that this objective should shift the responsibility for taking decisions from the consumer on to the regulator*'. Our concern is that this non-acceptance of responsibility by the regulator makes it more likely that cases of consumer detriment, regardless of the consumer's responsibility, will unfairly rest with product providers and distributors.

We welcome the recognition in the third principle that consumers must be responsible for their own decisions, though we wait with interest to see how this will be applied in practice, and in particular whether this principle will be applied across the regulatory system as a whole, especially by quasi-regulatory bodies such as FOS. If the principle is important enough for the

FCA to take it on board, then it should likewise be built into FOS to ensure regulatory consistency.

We also agree with the ruling out of a number of have regards regarding public understanding, financial inclusion and diversity, but we find it surprising that the FCA does not appear to have a specifically prudentially-focussed objective, especially in view of the comments in Box 4E. Finally, we believe that Item 4 of the FCA's objectives should read; '*the FCA must, so far as is compatible with its strategic and operational objectives, discharge its general functions in a way which promotes competition and facilitates* ***access for consumers to financial products and markets'***.

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

We support the Government's proposed arrangements for governance and accountability. In particular, we welcome the Government's proposal that the FCA should retain the Practitioner and Consumer panels, put the Smaller Business Practitioner panel on a statutory footing, and to subject the FCA to audit by the NAO.

We are concerned however that these proposed arrangements do not address the governance and accountability of hanging institutions such as the Money Advice Service and FOS. The actions of these institutions have a material impact upon the financial services industry, and therefore it is important that they are held accountable and governed appropriately. We elaborate on these issues later in this response.

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

The industry is already responding to this issue in the FSA's discussion paper (DP 11/01) on product intervention. We are therefore concerned that the allocation of powers to the FCA to ban products and intervene in the product lifecycle pre-empts the outcome of this consultation, throwing into question the consultation process on the issue. It not only indicates that industry influence is unlikely to have a material affect on what is proposed, it also shows that the Government is not giving recent rule changes and initiatives around product governance a chance to embed.

More substantively, we feel that giving the FCA the power to ban products that it feels are problematic creates an unwelcome opportunity for use of unfettered judgement by the regulator. Although there is recognition that '*an appropriate degree of certainty for firms*' is needed the consultation fails to explain how this will be safeguarded, and how hasty judgements or, worse, abuse of power, will be prevented. We feel the Government would be well-advised to consult further on '*principles governing the circumstances under which it will be used*' before granting this power to the FCA, rather than the reverse as currently planned.

The regulator should also be wary of the unintended consequences. Our primary concern with the proposed power in this respect is that if the FCA can potentially intervene before products come to market, this acts as a deterrent for firms to produce new products. This will stifle innovation and competition, and could restrict investment in businesses. Firms already face great uncertainty when producing new products due to potential changes in rules and regulations, such as when a change in tax treatment can either dramatically alter a product that has been set up to capitalise on an initial rate of tax, or make it uneconomical.

These concerns are only slightly mitigated by the recognition of the fact that the FCA should not pursue a zero-failure regime that removes responsibility from consumers. We strongly support the TSC's belief that '*financial markets are primarily about the management and pricing of risk, not its removal*'. Again however, we must question whether FOS will also recognise consumer responsibility, as a regime which permits failure is meaningless when there is a quasi-regulator which can make policy diluting or removing consumer responsibility based on individual consumer complaints.

Equally, we have concerns with the Government's refusal in paragraph 4.67 to accept that a product-banning power represents a transfer of responsibility from firms to the regulator. We believe that these powers could have the negative effect of giving implied validation to products: it would not be unreasonable for the public to interpret non-intervention by the FCA at an early stage as acceptance that the product is fit for purpose.

Finally, we have concerns with the new provisions which '*enable the FCA to use FOS more explicitly as a source of intelligence and require it to consider and act, if appropriate, on issues the FOS brings to its attention*'. We believe that this confuses the roles of the FCA and FOS. FOS is responsible for consumer issues, may not be subject to the same guiding principles of consumer responsibility, and certainly should not act as the 'intelligence' arm of the FCA.

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 have no objection to the broad principle of transparency; however, we feel the section on using transparency and disclosure as a regulatory tool is not clearly worded and the purpose of transparency has not been well-defined. If the proposal is to use transparency as a tool to illustrate and clarify regulatory requirements, there is no need for transparency to pre-empt due process. Similarly, if the purpose of using transparency would be to prevent customer detriment, then the counter-risk of unfair treatment to firms must also be recognised and adequately mitigated.

It is therefore our strong view that the principle of transparency must be underpinned by a requirement for adequate due-process that protects firms' reputations and commercial interests against weak judgments. Where there is a risk that judgment-based regulatory actions or decisions will be published that could be prejudicial to a firm, the firm must be given the opportunity to understand the basis on which the judgment has been formed and at a minimum be given the opportunity to make its own interventions, to ensure that the judgments are reliable. In fact, the current system applies an important separation of investigation and prosecution that needs to be preserved in the interests of natural justice. The example of Legal & General's successful Tribunal case illustrates the problems that will arise if supervisors are allowed to return to making and acting upon judgments based on inadequate information.

There is an implication in the Consultation that the FSA are already using disclosure to look beyond rule-book compliance to encourage good practice across the industry. This is very open-ended and we are not sure how it differs from the Treating Customers Fairly (TCF) remedies for firms. Equally, it seems to suggest that disclosure, or threat of disclosure, can be abused to give the FCA *carte blanche* to take whatever action it wishes.

We also believe that any departure from the need for new powers to contain safeguards to ensure a balance between the interests of regulated firms and consumers risks damaging the important relationship of trust which needs to exist between regulator and regulated firm. This relationship has been built on firms providing information voluntarily in a relationship of openness and trust and could be easily undermined by an over-zealous approach to the disclosure of commercially sensitive or confidential information on the part of the regulator. It is important that this does not lead to a more legalistic environment whereby firms only disclose the minimum information necessary to discharge their statutory obligations.

With regard to the new power to direct firms to withdraw misleading financial promotions, we feel that specific guidelines as to what constitutes a 'misleading' promotion are necessary. We would also like more clarity as to what would trigger a withdrawal; would the FCA act alone, or could it be triggered by competitor action?

We find the proposal to allow the FCA to publish warning notices completely unacceptable.

It bypasses the safeguards of FSMA and deprives firms of their right to due process. Public censure rightly requires due process involving a warning notice, a decision notice and finally a published final notice. Warning notices merely signal the start of an enforcement action, before any real or material actions to investigate the matter have taken place. Not all warning notices lead to a final notice or enforcement action being taken, specifically when there is no substance found to any hint or allegation of wrongdoing. To allow the publication of warning notices would herald an era where the regulator was free to cause loss and disruption to a firm, or indeed the wider industry by declaring that it thought certain actions or practices warrant investigation. Without substance or even firm engagement, the potential for reputational damage to firms would be very significant, and such damage would not be corrected by publication of a notice of discontinuance. As such, the safeguards that the Government proposes to protect firms against censure, are weak and would not do anything to protect against reputational damage in a media focused world.

In addition there are potential unintended consequences that the consultation does not seem to have considered, all of which mitigate against natural justice:

- Firms may find that their ability to resist demands made by the regulator in the early stages of a potential enforcement action (i.e. before any public reservations) is inhibited.
- There is the risk that a public warning notice may lead to a civil litigation against a firm, thereby exposing the firm to 'double jeopardy' and it having to defend itself in two separate actions.
- There is a risk of reputational damage to the regulator if a firm is vindicated in a high-profile action. In this event, it is not clear what processes there are for vindicated firms to recover damages.
- The potential disruption to a firm and wider industry appears to undermine the core objectives of the new regulatory bodies of financial stability and enhanced confidence in the financial system.

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

We believe that consideration of these issues should be postponed until the final outcome of the BIS consultation and the Independent Banking Commission report.

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 agree with these proposals and are pleased that the Government has decided that the UK Listing Authority (UKLA) will remain part of the FCA. However, we are concerned by the proposal for the FCA's statutory objectives to be extended directly to the listing regime. The regulatory focus of the UKLA and its priorities should remain different from the rest of the FCA. Primary and secondary market regulation is based on market transparency to enable investor decision-making and maintaining the competitiveness of the UK market. As the UKLA does now, we believe that the legislative framework for the FCA should retain a discrete regime for the listed markets reflecting the fact that the UKLA carries out a different kind of regulatory function which is neither prudential nor conduct based.

The proposal to increase the UKLA's powers to obtain information from issuers by way of a skilled person report is without justification. We see this as adding to the regulatory burden and costs of being listed in the UK when there has been no failure in the listed markets to justify a need for increased powers.

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

It is disappointing that the Government has not specified in the paper how the legislation to ensure co-ordination between the PRA and the FCA will work, particularly given that it highlights the high degree of connectivity between prudential and conduct issues. Further detail on how the PRA and FCA intends to reconcile conflicting issues such as policyholders' protection and expectation of future return and balance sheet soundness is still needed.

In addition, there appears to be an assumption that duplication and inefficiencies can be 'coordinated away'. However the paper does not address the fact that each authority may have legitimate, and different, interests in some parts of a firm. Much of the content currently located in the 'High-Level Systems and Controls' section of the FSA Handbook – for example, requirements relating to central control functions such as Risk and Internal Audit – will be relevant to both prudential and conduct regulation. It is likely that both authorities will want to form a view of the competence of, say, the Internal Audit function to oversee the quality of relevant controls. Little has been said in the paper about how this apparently inevitable duplication of oversight will be managed. At the very least, the mechanisms put in place to deliver co-operation between the authorities should have an overarching principle that the authorities should seek, in their co-ordinating activities, to minimise disruption and inefficiency for regulated firms.

We would also like more clarity regarding what will be included in the Memorandum of Understanding (MoU), as we feel that the non-exhaustive list of key areas that is provided is light on detail. It is also not clear how the co-ordination of regulators will work at a practical level. For example, will firms still have to have two ARROW visits?

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

We support these proposals on the grounds of financial stability. However, such a veto must be seen to be an extreme and unlikely event. We discuss below the related issue of risk transfer between different parts of the financial system as a result of FSCS financing arrangements which include assumption of asymmetric risk.

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

With any system where there is a split between regulators, authorisation will be a complex matter. We are concerned that the processes proposed under both options are likely to lead to an impact on the time it takes a firm to be authorised or vary its permissions.

However we would prefer the first option with an application for a dual-regulated firm being made separately to each regulator. We believe that this represents the clearest and most efficient split without the need for firms to determine which regulator should take the lead. We would however like to see clear timeframes and Service Level Agreements put in place for both regulators in relation to the authorisation process.

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

We agree with the proposals.

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

Whilst we agree in principle with the proposals, we question how co-ordinated the work between the PRA and FCA would be in practice. For example, if the PRA removed approval for a controlled function in relation to prudential matters due to what it perceived as a lack of technical knowledge, but the same individual was also approved by the FCA to carry on a controlled function, would the removal by the PRA have an impact?

We are also unclear as to why the consultation paper gives the example of the CEO requiring approval only under the PRA – we would assume conduct of business matters would also clearly fall within the significant influence of the CEO. We are concerned therefore that a split between the PRA and FCA could result in a significant increase in the number of approvals required.

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

We believe that the proposals in relation to passporting are practical given the existing European legislation on these matters.

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

We agree with the Government that neither regulatory authority should seek to promote or favour one type of ownership over another. All ownership structures should be treated equally.

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

We have no comments to add on these proposals.

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?**

When supervising financial groups, there needs to be recognition that insurers and investment firms operate differently to banks, and therefore should be regulated accordingly. In particular, unlike banks, insurance groups are required to hold their capital closer to their customers which reduces risk of customer detriment.

We are unclear as to what the Government means in terms of a 'power of direction'. Unregulated firms are by their definition outside the control of the FSA. Recent changes to the controlled functions have sought to bring in an element of regulation over unregulated holding companies with the introduction of the CF00 Parent Entity (Significant Influence Function) and we are not clear if this recent change is now seen as insufficient, and whether it will be retained should a new 'power of direction' be introduced. We are also unclear as to what a 'power of direction' may mean in practice, particularly how this would work where such direction impacts on the decision of the company's board where directors have their own legal responsibilities.

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 would expect there to be clear and defined grounds for an FCA review of, and objection to, change of control applications for dual-regulated firms where these are under the consideration of the PRA as the lead authority. Clear definition is needed to avoid any risk of wholesale review from first principles by the FCA of an application which has already been considered (and approved) by the PRA. The basis on which the FCA can object to a change of control on money laundering or terrorist financing grounds should be tightly defined. Clarity on the PRA and FCA's respective roles in change of control applications for dual-regulated firms will be important for firms' regulatory certainty.

The consultation suggests that where there are FCA solo regulated firms in a group with a dual-regulated entity and the PRA approves the change of control in relation to the dual regulated firm, the FCA will be expected to '*have regard to*' the PRA's assessment before making its own decision in relation to the FCA solo regulated firms in the group. Much greater definition on the meaning of '*have regard to*' is needed to understand how the PRA and FCA will interact on change of control applications for groups where firms straddle the two regulators. A situation where the PRA is satisfied following its prudential assessment for the dual-regulated firm(s) in the group, but where the FCA could refuse the applications for the FCA solo regulated firms in the group, albeit having had regard to the PRA's conclusion, is unworkable. We would suggest that there needs to be specific and clear definition of what in the PRA's assessment the FCA must have regard to and the scope for the FCA to reach alternative conclusions.

We agree with the proposals regarding Part VII transfers and are pleased that the Government do not wish to alter their substance, as we feel that they are important in providing policy holder protection. It is important that the obligation for the PRA to consult with the FCA does not cause delay to the process.

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

We support these proposals.

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

We fully support these proposals, as they seem to maintain existing arrangements.

We have been concerned at the substantial increase in fees over recent years, and so we welcome the decision that the PRA and FCA should be subject to a requirement to use their resources in the most efficient and economical way. We believe that the decision to make both PRA and FCA subject to audit by NAO so that the Public Accounts Committee can examine their spending will provide more oversight than at present. We also believe that the Treasury Select Committee should regularly examine the annual plans and reports of these bodies.

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

We would have liked some clarity on the FSCS arrangements for pre-funding (if any) as they relate to insurance or investment companies, as they are not mentioned in this consultation. We feel that while pre-funding is appropriate and necessary for deposit takers, given the liquidity risk and the systemic undermining of confidence if there is any 'run' on the institution, the failure of an insurance company is an entirely different matter. Here, the liabilities unwind over a period and coupled with the very different capital requirements and fundamentally different leverage position means that there is little evidence of the need for pre-funding.

Likewise, for investment companies, the assets are generally held with a custodian. Expecting insurance companies to provide pre-funding for deposit-takers through a general pool in our view creates an asymmetric and unfair level of risk for insurers and investment companies which could only be justified on the basis that it is to provide a buffer for defaults in other parts of the financial services industry.

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

The reform of regulation presents a clear opportunity to make a clear determination over the role of FOS. FOS was originally established as an alternative to the courts to adjudicate on individual disputes taking into account all the circumstances of the individual case. The governance and accountability of FOS was determined in the light of its role as laid out in statute.

The reality is now very different. The FSA, through its rules in DISP, requires firms to take account of FOS decisions within firms' complaint handling processes. Thus FOS decisions have evolved into policy decisions, which only have to take account of, not follow, law and regulation. It is against all notions of good regulation for policy precedents to be set without having to follow regulation and law and indeed without any consultation or robust and transparent decision making process.

Additionally, the fact that the FSA cannot bind FOS in cases with wider implications has resulted, we would argue, in an inability for the regulator to achieve swift action in cases of consumer detriment such as PPI. We are also concerned that the ability of the new FCA to protect customers will be undermined as it is FOS decisions rather than FCA rules which drive the industry to make changes, such as to literature or product design. This means that there is no single point of accountability for consumer regulation.

We believe that the remit of FOS should be returned to making individual decisions, with the FCA given the role of determining which of these decisions should be made policy for firms to follow.

It is therefore our view that the Consultation's proposal to consider whether there are further measures which could make the respective roles of the FOS and the FCA more distinct is totally inadequate. We believe that it is vital that the FOS is held to be accountable for its actions and appropriate engagement on this issue by government is required.

Finally, a related issue which should be addressed in the context of financial regulatory reform is the future regulation of Claims Management Companies (CMCs), which account for 28% of all FOS complaints. Unsatisfactory regulation allows CMCs to generate quick profits while offering poor value to consumers, and contributing a 'compensation culture' in the UK. The Ministry of Justice (MoJ) is currently reviewing regulation of CMCs, and we support the ABI's proposal that MoJ and HMT should jointly assess whether the FCA's remit might sensibly be extended to include CMCs. Consideration should also be given to requiring CMCs to make a contribution to the running costs of FOS, particularly where a complaint they have advanced had been judged to be frivolous.

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

The accountability of these 'hanging institutions' is an issue which needs to be properly addressed. There is a feeling that, despite the Hunt Review and frequent industry representations, the Government has very much left this issue as an afterthought in its regulatory reform proposals and has failed to undertake a wholesale and objective review of the existing framework and objectives. The proposals in the paper whereby the FSCS and FOS follow the lead of the Money Advice Service and publish an annual plan and consult on it is, we believe, inadequate in creating any accountability for these bodies. As noted above,

appropriate engagement with industry is required to address ongoing and significant issues with these institutions: whilst the involvement of the NAO is welcome, it is not sufficient.

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

We feel that this is potentially one of the most important issues discussed in the consultation. We have no issues with what is outlined, but we would question whether these remain highly aspirational: how much influence will the UK's domestic regulatory bodies realistically have with regard to international coordination? Our experience of the Solvency II process and associated stress tests suggests that the newly-created EU regulators are already exerting disproportionate influence relative to their domestic counterparts, while the Lamfalussy process for EU financial services legislation can impose regulations on member-states including the UK without any domestic parliamentary scrutiny.

In order to maintain influence in Europe, the UK authorities will need to do more to influence the process of setting EU rules. This is likely to require a high degree of technical skill, as well as new negotiating and influencing skills and a higher level of political awareness on the part of UK representatives. These skills should be taken into account when selecting UK representatives on the ESAs and more generally in the recruitment of staff to the UK regulatory bodies.

Finally, we would question why, in this consultation, the key European policy issues cited as coming up in the next year are very bank-focussed. This downgrades vital insurance-based issues such as Solvency II, EU-wide policyholder protection issues and the extension of Solvency II to pensions. The UK insurance industry is a vital part of the UK economy, managing investments amounting to twenty four percent of the UK's total net worth and contributing the fourth highest corporation tax of any sector. As such, greater consideration of the issues that are specifically material to its success and impact on the wider UK economy is required.

CONSULTATION RESPONSE

A response to HMT Consultation "A new approach to financial regulation: building a stronger system"

This paper sets out the response of the Listing Authority Advisory Committee (LAAC) to the above mentioned Treasury Consultation (Cm 8012) published in February 2011. The response is limited to those parts of the Consultation that are within LAAC's sphere of interest, namely the parts that affect listing and admission of securities to regulated markets, and the regulation of primary markets more generally.

The paper does not, therefore, attempt to answer the all of the specific questions put in the Consultation, but raises a number of points that have more general significance and should, in LAAC's opinion, be taken into account in the drafting of the primary legislation and the implementation the new regime.

These are as follows:

1 FCA objectives and approach

We support the idea, set out in paragraph 4.111 of the Consultation, that the general objectives of the Financial Conduct Authority should apply to all its constituent parts, including the primary markets and listing functions. In our view, that follows naturally from the Government's conclusion that the UKLA cannot sensibly be separated from the rest of markets regulation

We believe, however that the listing function will need to have the scope to be able to implement those objectives in different ways to other parts of the FCA, such as those more focussed on retail conduct. We think it is very important that this is recognised in the primary legislation. A single set of objectives will need to have qualifiers which indicate how these objectives will be implemented in relation to markets.

We also believe that it would be helpful in that context if the Government were to make it clear that it is not looking for the FCA to deliver a step-change in the regulation of listed and primary markets. Otherwise, there is a risk that, with a single overarching objective, and an approach – noted below – in which every market participant is to be defined as a "consumer", that over time there would be an inappropriately retail-oriented approach brought to listed and primary markets.

In terms of drafting, we do not think that the term "consumer" is the right one to capture all users of the market (whether large institutional investors, such as insurance companies or pension funds, or small, low net worth individuals). A more suitable term to capture the constituency we are interested in would be "market user".

There is also a potential tension between the strategic objective – protection of the UK's financial system – and some of the operational objectives – securing an appropriate degree of protection for consumers; and facilitating market choice. The safest market might, to some, be one where risk is reduced to an absolute minimum. However, such markets will have limited choice. The key is to achieve a sensible balance between appropriate safety, with opportunity for more experienced investors to take their own risks. Again, we think it would be helpful if the fact that the FCA will need to strike a balance between these objectives was recognised in the legislation.

2. Consumer protection and the relationship between wholesale and retail markets

Turning more specifically to how this will unfold in practice, there are important issues for the FCA around the distinction between consumer and investor protection, and between wholesale and retail markets.

We think that the Treasury Select Committee, quoted in paragraph 4.51 of the consultation paper, is right when it says "financial markets are primarily about the management and pricing of risk, not its removal". In the context of the listing authority, this translates into ensuring that proper disclosure is made in prospectuses, within the limits prescribed by the prospectus directive regime, not refusing admission to products that are deemed to be too risky for certain investors[1].

We believe that the listing authority has much less ability to intervene in relation to particular products than the broader FCA's conduct function. The conduct of business and listing areas of the FCA operate under different EU directive regimes. While the conduct of business framework may give considerable scope for product intervention (for example, by requiring specific point of sale disclosures or even by banning products), the listing authority, by contrast, is much more restricted in this area. It can refuse admission to the regulated market, but only in extreme cases. Where it cannot refuse admission, it is unable to require more disclosure in a prospectus than is required under the prospectus directive regime (which is a maximum harmonisation regime).

The focus of legislation therefore should be to reinforce disclosure requirements for the fullest possible range of products admitted to the UK's markets, but with graded conduct of business rules designed to protect the most vulnerable (for example, by imposing suitability

[1] Even if it could require additional disclosure for certain products, in pursuit of the consumer protection objective, it would be potentially self-defeating for it to do so, given that the issuer would be able to seek approval of the prospectus by a competent authority elsewhere in the EEA and then to passport that prospectus into the UK for admission to the regulated market. One consequence would be that the FCA would be distanced from broader market developments, and thus less able to discharge its broader objectives effectively.

or appropriateness duties on the intermediaries that sell products to them or even, in some extreme cases, banning sales of particular products to them altogether). But those rules should allow the more experienced investors to judge the investment opportunities for themselves and take whatever risks they make think appropriate. This needs to be made clear in the legislation to avoid misunderstanding and a possible regulatory creep towards risk aversion in the future.

The consultation paper refers in several places to the links that exist through the transaction chain between retail products and services and wholesale activity. Where there is such a chain of transactions, the issues of consumer protection should be dealt with primarily through MiFID and conduct of business rules rather than through rules applying to listing. Obligations of disclosure to retail investors should not be passed up the chain to the originator of a product. The onus of disclosure to retail consumers should vest in intermediaries at the point of sale to those consumers. Whatever retail protection may be required can be provided through conduct of business rules imposed on those who distribute to retail customers (such as, for example, suitability or appropriateness duties carried out by the distributors, based on their understanding of their customer and (from their reading of the prospectus) the product). It would be preferable if the legislation recognised that most of the objectives here can be achieved through other functions of the FCA.

From the perspective of the listing authority, we also think that it is important to maintain the almost binary distinction made under the prospectus directive between wholesale and retail securities (the former being defined by their denomination of EUR 50,000, shortly to rise to EUR 100,000). Under that regime, there is no place for retail style disclosure in a wholesale prospectus and the fact that there may be a transaction chain that includes retail investors will be largely irrelevant. Wholesale denomination prospectuses should be written solely for wholesale investors, whether or not there may be a retail element in the product chain.

3 Competitive position of UK markets

We note that maintaining the international competitiveness of the UK's financial markets is not proposed to be a self-standing objective of the FCA. However, we believe that the FCA, and the listing authority in particular, need to ensure that the UK's financial markets do continue to attract a diverse range of issuers and financial products, both domestic and international, and that the UK should actively seek to maintain its position as one of the world's most important financial centres. In the absence of restrictions on international movements of capital, UK investors will be able to buy investments wherever they are issued and whoever approves the prospectus. And they will do so, particularly if the UK approved market becomes limited in scope in the interests of protecting consumers and the only way to find higher returns on investment (usually involving higher risk) is to look to other markets.

In addition, the knowledge of particular innovative product lines that is obtained by the listing authority will be of considerable benefit to other areas of the FCA and also, through the information exchange mechanisms that will exist between the FCA and the Prudential Regulatory Authority, the prudential supervisors.

We believe, therefore, that the FCA should have maintenance of the UK's international competitive position as part of its objectives. We recognise that one concern behind giving a regulator an international competitiveness objective is that it could give incentives for lower regulatory standards. However, wherever there has been discretion for the UKLA to set standards, it has generally been used to set higher standards.

4 Issues by UK-regulated institutions

Where an issuer is also an FSA-regulated firm, the UKLA is at present able to tap into the very extensive knowledge of the issuer that the FSA's regulatory supervisors have. This is particularly important in challenging financial conditions, to ensure that the disclosure made to the market in a prospectus, when the institution needs to raise fresh capital, provides a proper basis for the investment decision. Under the new arrangements, the prudential supervision of many of the larger financial institutions will be carried out within a different organisation – the PRA.

It will be very important, therefore, that under the new arrangements, it is clear that the listing authority is in fact – and is seen by the market to be – responsible only to ensure that the prospectus contains information that is actually in its possession or that can reasonably be obtained by it. It will be particularly important to ensure that any information obtained by senior officials of the FCA as members of other regulatory bodies, such as the PRA, is not imputed to the listing authority.

We would expect that the legislation (and/or its implementing rules) will address the need for appropriate regulatory cooperation and information exchange between different elements of the regulatory framework.

Listing Authority Advisory Committtee

Direct line: 0207 995 1415

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

13 March 2011

Dear Sir/Madam,

RESPONSE TO Cm 8012 CONSULTATION

Thank you for the opportunity to participate in the HM Consultation "A new approach to financial regulation: building a stronger system".

I am pleased to enclose the a paper setting out the response of the Listing Authority Advisory Committee ("LAAC") to HM Treasury's Consultation on "A new approach to financial regulation: building a stronger system" (Cm 8012). The LAAC is composed of very experienced users of the financial markets, including issuers, investors and financial intermediaries so in my view the response is a valuable contribution to the consultation process.

If you have any queries in relation to this paper or require further information please do not hesitate to contact me.

Kind regards,

Yours sincerely

Andrew Tusa

Chairman, The Listing Authority Advisory Committee

The Listing Authority Advisory Committee was established as an advisory committee to the FSA Board.

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

14 April 2011

Dear Sirs

A new approach to financial regulation: building a stronger system

LV= is a Friendly Society Group consisting of life assurance, general insurance and asset management companies. We sell short term & long term protection products, investment products and pensions both directly to customers and via intermediaries. As such, we would be authorised and regulated by both the PRA and FCA.

We have provided answers to the specific questions in Annex 1 but have provided some general comments below.

General comments

We largely welcome the Government's proposals in this consultation paper. We feel that the Consultation Paper is thoughtful and well-presented and substantially improves on the proposals in the initial consultation. It has many positive points, for example, the clear statement that consumers have responsibilities is welcomed.

In addition, the need to retain a consultation and cost benefit analysis regime is welcomed, however, there is no mention of how the CBA regime will be improved to make it more meaningful than it is at present.

We foresee, however, that problems might arise in the future if close co-ordination between the PRA and FCA only exists at the high-level through MOUs and cross-membership at board level and is not embedded at the day-to-day working level.

Yours faithfully

Debbie St Cyr
Group Compliance Manager – Policy & GI

Annex 1

Q1 What are your views on the likely effectiveness and impact of these instruments as macro-prudential tools? AND
Q2 Are there any other potential macro-prudential tools which you believe the interim FPC and the Government should consider?

The acknowledgment that many of the tools available to the FPC are untried is a potential for concern. We would ask, therefore, that the tools are rigorously stress-tested against possible scenarios. In order to ensure that any unexpected consequences are kept to a minimum, the scenarios need to take account of: prevailing market conditions, economic cycles, ESRB developments, international regulatory developments.

In addition, the focus of the tools available to the FPC appears to be developed in relation to the banking sector. The recognition that insurers do not pose a classic systemic risk to the financial system goes some way to explaining this emphasis. It needs to be recognised, however, that insurers have very different operating models to banks so specific tools need to be developed for insurers despite the likely limited application.

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

The proposed mechanisms appear to be largely appropriate. We do, however, have one concern regarding the statement in the paper that the legislation will set out which tools will require the FPC to consult on a policy statement about the use of the tool. We feel that, given the significant impacts these tools will create, FPC should be required to issue a policy statement on every macro-prudential tool it may wish to use. The policy statements should set out the circumstances in which the tool can be utilised and the likely resultant effects on the financial services industry and the economy as a whole.

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

No comment

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

As per our concerns outlined above, we feel that the macro-prudential nature of PRA's strategic objective is bank-centric. As it is acknowledged that insurers are not likely to cause systemic risk, prudential regulation of them is micro in nature. It is questionable, therefore, whether this strategic objective is entirely appropriate for the insurers which PRA will regulate. We feel that the strategic objective should be expanded to encompass micro-prudential elements as well as financial stability.

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

We agree with PRA's scope as we feel that insurers should be prudentially regulated by PRA rather than FCA.

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

We broadly agree with the judgement-led approach that PRA will take, as a reliance on a pure tick box approach is not flexible enough to cope with all the risks inherent within firms and the financial system as a whole. We do have concerns, however, that the necessary skill set is not fully entrenched at the FSA to enable it to meet such an approach fully. As most of the PRA's staff will be made up of current FSA staff, we feel that there needs to be a relevant and specific training programme put in place. Such a training programme would help prevent PRA having to require firms to carry out as many expensive s166 reviews as now.

We are concerned that a judgement-led approach could provide an inconsistent approach between firms and could effectively bring in retrospective regulation or rules 'by the backdoor' where no consultation or CBA has been done. Any decisions based on judgement would need to be made clear and be on a sound footing so that the appeals process can be effective.

We also wonder just how much room there will be for judgement once the full set of CRD and Solvency II technical provisions have been established by the ESAs in Europe; especially any on national level supervision. It is essential that the PRA is fully engaged in setting such technical provisions if a tick box approach is to be avoided.

Q8 What are your views on the proposed governance framework for the PRA and its relationship with the Bank of England?

We broadly agree with the proposed governance arrangements but would ask that the non-executive members of the Board include people with an insurance background.

Q9 What are your views on the accountability mechanisms proposed for the PRA?

We broadly agree with the proposed accountability mechanisms, however, we feel that the National Audit Office and not HM Treasury should be able to determine when a 'value for money' review is to be carried out as it does for other Government departments.

Q10 What are your views on the Government's proposed mechanisms for the PRA's engagement with industry and the wider public?

We welcome the inclusion of consultation processes in this Paper. As the majority of rules and guidance will be coming from the ESAs in the future, we would welcome the PRA getting the industry involved at a much earlier stage e.g. when the EU consults on underlying Directives and technical provisions rather than when these provisions are transposed as transposition consultation is often academic. FSA has started to increase this earlier stage inclusion e.g. the setting up of the HMT/FSA IMD industry working group.

Q11 What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the FCA?

We broadly agree with the objectives proposed for the FCA. The reference to consumer confidence and choice are important but we feel that these should dove-tail with the Government's Policy objectives, such as, increasing savings and financial inclusion.

Q12 What are your views on the Government's proposed arrangements for governance and accountability of the FCA?

We broadly agree with the proposed arrangements for governance and accountability of the FCA, however, our comments above regarding National Audit Office reviews applies equally here.

Q13 What are your views on the proposed new FCA product intervention power?

We accept the need for proactive regulatory intervention to prevent unfair treatment of consumers, however, such proactive intervention should not be focused on product development. Not withstanding the fact that we believe FSA's existing powers are more than sufficient to meet these requirements; all the 'mis-selling scandals' of the past, such as, pensions, precipice bonds, endowments and PPI, were caused by the selling practices of the distributors and were not an issue with the underlying products.

We feel that the shift of focus away from selling practices to product development is mis-guided. It is very easy for a perfect product to be mis-sold by a distributor. As such, we do not feel that any additional powers are needed.

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.*

We agree that the FCA should be more transparent, for example, providing market and product trend information in its annual reports.

We agree that the FCA should have the power to ban mis-leading adverts, as the FSA does now. We do not feel, however, that the ban should be published without due process being followed i.e. the firm either agrees that the advert is mis-leading or the full appeal process has been completed.

We are not comfortable with the proposal to enable both FCA and PRA to publish warning notices even allowing for the proposed safeguards: discretionary power, impact assessment, publication of discontinuation of enforcement. There is a risk that a firm could be subject to civil litigation based on the warning notice or that claims management companies could use the warning notice as the trigger for potentially spurious claims. Additionally, if the enforcement action is subsequently stopped, this could provide reputational damage for the regulator.

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?

We agree with the proposal that FCA should have a credible and effective role in competition.

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.*

No comment.

Q17 What are your views on the mechanisms and processes proposed to support effective coordination between the PRA and the FCA?

We broadly agree with the proposals to have cross-membership of boards, Memorandums of Understanding and scrutiny of the framework by the Treasury Select Committee. The devil will be in the detail. It is vital that PRA and FCA co-ordinate at all levels to avoid duplication of activities for both the regulator and firms. As such, we feel that full consultation of the detailed framework needs to be consulted on so that the industry can have input to the system that will regulate it.

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?

We agree with the PRA having the ability to veto FCA enforcement actions in these limited circumstances.

Q19 What are your views on the proposed models for the authorisation process – which do you prefer, and why?

We feel that the alternative approach should be used with FCA being used as the single gateway for all firms whether they are regulated by FCA only or by both FCA and PRA. Although FCA would have to work closely with the PRA behind the scenes, this approach would help firms not have to duplicate the provision of information.

Q20 What are your views on the proposals on variation and removal of permissions?

We agree with the proposals to give both the PRA and the FCA the FSA's current powers to vary and remove permissions.

Q21 What are your views on the Government's proposals for the approved persons regime under the new regulatory architecture?

Although we accept that each regulator will have an interest in the approval of persons carrying out controlled functions, we are concerned about the practical way this approval process will work. We do not see how some controlled functions can only apply to one regulator e.g. Directors, non-executive Directors and Chief Executive Officers have as much influence on conduct issues as they do on the prudential aspects of a firm. As such, we believe that a duplication of approved persons will exist, especially for Groups which contain both solely and dually regulated firms.

We feel that it is essential that a single gateway is created for approved persons as we have outlined above for authorisation. This would cut down on administration for firms and help provide a more effective co-ordinated approach for the regulators. As such, we feel that one of the regulators should take the lead in the application

process and work with the other regulator behind the scenes to provide approval to firms.

Q22 What are your views on the Government's proposals on passporting?

The proposals on passporting appear appropriate.

Q23 What are your views on the Government's proposals on the treatment of mutual organisations in the new regulatory architecture?

As a mutual organisation, we welcome the proposal that the regulators have to provide additional cost benefit analysis in consultation papers if the proposals have different impacts on mutual organisations.

Q24 What are your views on the process and powers proposed for making and waiving rules?

We agree with the proposal that both the PRA and FCA should have rule making and waiving powers, however, we are concerned that in certain areas, such as systems and controls, there is the possibility of overlap developing if the planned co-ordination between PRA and FCA at the detailed technical level does not occur.

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?*

As a group, we welcome the proposal that the PRA and FCA should co-ordinate their activities to ensure effective group supervision. We also support the proposed power of direction to be used when PRA and FCA have been unable to reach agreement.

Q26 What are your views on proposals for the new authorities' powers and coordination requirements attached to change of control applications and Part VII transfers?

No comment.

Q27 What are your views on the Government's proposals for the new regulatory authorities' powers and roles in insolvency proceedings?

No comment.

Q28 What are your views on the Government's proposals for the new authorities' powers in respect of fees and levies?

The proposals appear sensible, although we are concerned about the potential duplication of administration and information provision which will lead to additional costs for both firms and regulators. As the cost of regulation has a knock on effect to the premiums / fees paid by customers, we would ask that such duplication be removed where possible.

Q29 What are your views on the proposed operating model, coordination arrangements and governance for the FSCS?

We are comfortable that the PRA and FCA will have joint responsibility for the FSCS.

Q30 What are your views on the proposals relating to the FOS, particularly in relation to transparency?

We welcome the proposals.

We would like to take this opportunity to request that claims management companies (CMCs) are regulated. By the time we receive many complaints from customers, they have already signed a contract with the CMC which states that they can not come to us directly. We feel that this practice should be stopped and that CMCs must tell customers that they will receive the same treatment by going direct to the firm and will not have to pay a fee. We also feel that CMCs should contribute to the cost of FOS by paying a case fee as firms do now.

Q31 What are your views on the proposed arrangements for strengthened accountability for the FSCS, FOS and CFEB?

We welcome the proposal for increased accountability.

Q32 What are your views on the proposed arrangements for international coordination outlined above?

The ESAs will be setting binding technical standards for UK financial services firms so they will become the main source of detailed regulatory requirements. As such, members of PRA and FCA will need to be able to negotiate and influence at the political level rather than purely at the technical level as now.

Ends.

LLOYD'S

Financial Regulation Strategy
HM Treasury
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London
SW1A 2HQ

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

14 April 2011

Dear Sirs

A new approach to financial regulation: building a stronger system

I am submitting this response on behalf of Lloyd's.

We welcome the opportunity to respond to this consultation paper, having responded on 18 October 2010 to HM Treasury's earlier consultation on this subject. We are pleased to note that the proposals have progressed from the earlier consultation. HM Treasury has listened to feedback provided and in many areas there are clear improvements. At the same time, we consider that the proposals would benefit from further enhancement or clarification.

We welcome many of the consultation paper's proposals. In particular, we note our support for the following:

- The intention that the PRA will be responsible for prudential regulation of the Society of Lloyd's and Lloyd's managing agents, as well as for the Society's activities of ensuring the adequacy of members' resources and Lloyd's central assets.
- Recognition that the PRA must act in a way which recognises that insurance business models are different to those of banks, especially in terms of liquidity risk, and that insurance firm failure is much less likely to be of systemic importance. It is appropriate for supervision of insurance to be less intrusive than supervision of banking.
- The proposed legal duty on the PRA and FCA to co-ordinate their activities and a requirement on both bodies to agree and publish a Memorandum of Understanding (MoU) setting out how they will deliver the duty.
- Confirmation that the PRA will consult publicly on new rules. We would welcome a similar commitment in relation to the FCA's rule-making powers.
- Proposals to ensure that the UK is effectively represented in the work of the new European Supervisory Authorities.

Our remaining key concerns include:

- The absence of a requirement for the new supervisory authorities to have regard to the desirability of maintaining UK competitiveness.

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- The precise details of how supervision of Lloyd's and the Lloyd's market by the PRA and the FCA will work in practice and the extent to which duplication can be avoided.
- The need for a new Co-operation Agreement between Lloyd's, the PRA and the FCA.
- The possibility that dual-regulated firms and persons working for them could be subject to two separate authorisation processes run by different authorities.
- The substantial costs like to arise from the switch to the new arrangements and the possibility that the new system will be more expensive on an ongoing basis than the old.

Our responses to the specific questions posed by the consultation document are set out below. We have answered only the questions which we think are relevant to the Lloyd's market and where we think we have useful input to provide.

Financial Policy Committee

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

We support the statement that it is important to ensure external members of the FPC are able to offer insights from direct experience as financial market practitioners – not only in banking, but also other sectors such as insurance and investment banking.

The FPC's anticipated role means that it must have access to sufficient levels of insurance expertise. At least one member should have experience in insurance, to provide a more balanced and informed view.

Prudential Regulation Authority

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

(i) Strategic and operational objectives

We consider that the PRA's strategic and operational objectives are broadly appropriate. However, these objectives are very similar to those of the FCA, which may not facilitate the development of differentiated roles for the two authorities, possibly leading to ambiguity and overlap. The PRA's strategic objective will be contributing to the promotion of the stability of the UK financial system and the FCA's strategic objective will be protecting and enhancing confidence in the UK financial system.

Of course it is desirable that these objectives should be aligned. Nevertheless, the specific roles of the PRA and the FCA are not reflected in their proposed objectives.

(ii) Regulatory principles

We believe that it is important for both the new authorities to have regard to the desirability of maintaining UK competitiveness and encourage the Government to include this in the regulatory principles applied to both the PRA and FCA (Box 3.B of the consultation paper).

The UK financial services industry constitutes a substantial part of the UK economy. We recognise that this creates risks as well as benefits and that the recent financial crisis, which many observers blame on practices within the banking sector (internationally and in the UK), demonstrates the overriding importance of ensuring that all parts of the industry are properly regulated.

Nevertheless, financial regulation means that government agencies are much more intensively engaged in financial services than in other areas of the private sector and this engagement has a direct impact on the sector's success and profitability. In turn, the size and scale of the UK financial services industry means that it direct impacts the whole UK economy – as the financial crisis demonstrates. In 2010 financial services is estimated to have contributed about 10% of UK GDP in 2010 and employed around 1.01m people in September 2010[1]. It is a major contributor to UK public finances, paying £53.4bn in taxes in the year to 31 March 2010, 11.2% of total Government tax receipts[2].

Furthermore, financial services are international and UK financial services have a sound record of competing successfully with competitors in other countries. Regulation that puts the UK financial services industry at a disadvantage in relation to international competitors will therefore have a direct effect on the prosperity and economic success of the UK. We do not believe that requiring the new authorities to have regard for UK competitiveness would distract them from achieving their primary objectives. .

Notwithstanding the financial crisis, which demonstrated supervisory failings worldwide, many other important jurisdictions continue to insist that supervisory approaches take account of national competitiveness. The regulations establishing the European supervisory authorities instruct each authority to *"...take due account of the impact of its activities on competition and innovation within the internal market, on the Union's global competitiveness, on financial inclusion, and on the Union's new strategy for jobs and growth."*[3] In the US, the newly-created Federal Insurance Office (FIO), is required by law to consider the international competitiveness of insurance companies whilst reviewing how to modernize and improve the system of insurance regulation in the US.

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

We welcome the Governments' view that the PRA must act in a way which recognises that insurance business models are different to those of banks, especially in terms of liquidity risk and that insurance firm failure is generally less likely to be of systemic importance. We agree that a less intrusive supervisory approach is therefore needed for insurance than for banking.

We also welcome the proposal that the PRA should be responsible for the prudential regulation of the Society of Lloyd's and Lloyd's managing agents, as well as for the Society's activities of ensuring the adequacy of members' resources and Lloyd's central assets. Our earlier submission contained a detailed account of existing arrangements for the prudential supervision of the Lloyd's market, which work well. We strongly recommend that these

[1] Economic Contribution of UK Financial Services 2010, Jan 2011, The CityUK

[2] The Total Tax Contribution of UK Financial Services, Dec 2010, PWC for the City of London Corporation

[3] For example, Regulation No. 1094/2010, recital 12

arrangements continue. We are pleased to note that there was no suggestion in the consultation paper that they will be changed.

If the Government or new regulatory bodies are minded to change existing arrangements for the prudential supervision of the Lloyd's market, this must be the subject of public consultation. When the FSA took over the regulation of the Lloyd's market there was detailed public consultation specifically on Lloyd's regulation.

The Corporation of Lloyd's devotes substantial resources to ensure that risk is managed across the Lloyd's market. It is important that the UK's supervisory structure continues to take account of Lloyd's oversight of risk in the market and its role in ensuring capital adequacy.

A detailed account of how we consider the new arrangements should apply to the Society of Lloyd's and entities within the Lloyd's market is set out in the annex to this letter.

Solvency II is the FSA's largest single project and the biggest change in insurance regulation in Europe for over 30 years. It is imperative that the transition process to the new regulatory structure is well managed and does not prejudice the ability of the FSA/PRA and industry to ensure an orderly implementation of the new prudential solvency regime.

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

We note from the consultation paper that the Government has not yet finalised its views on appeal rights and processes. We believe that the PRA's decision-making process should be subject to appeals to the Upper Tribunal on 'full merits review', to ensure transparency, consistency and accountability. The PRA's set-up must take account of EU requirements such as the Solvency II Directive, article 297, which says:

> *"Member States shall ensure that decisions taken in respect of an insurance or a reinsurance undertaking under laws, regulations and administrative provisions implementing this Directive are subject to the right to apply to the courts."*

Q8. What are your views on the proposed governance framework for the PRA and its relationship with the Bank of England?

We support the Government's proposals on the governance framework for the PRA and its relationship with the Bank of England.

The PRA board should include non-executive directors with relevant experience of the financial sector, including insurance.

Q9. What are your views on the accountability mechanisms proposed for the PRA?

We agree with the Government's proposals on the accountability mechanisms for the PRA.

Q10. What are your views on the Government's proposed mechanisms for the PRA's engagement with industry and the wider public?

Continuation of existing commitments to consultation are essential. We agree with proposals to ensure that the PRA is under an obligation to publicly consult when it makes rules, as this will result in better drafted, better targeted and more effective regulation.

We note the suggestion that the requirement to consult might be "streamlined" when implementing EU rules. We do not support this proposal. A significant concern regarding the implementation of EU rules has been the extent to which they have been "gold-plated" when transposed into UK legislation. The ability of practitioners to challenge gold-plating will be significantly reduced if the implementation of EU rules is not subject to a proper consultation process.

Financial Conduct Authority

All insurance intermediaries, including wholesale insurance brokers doing business in the London market, will be FCA regulated. The FCA's internal structure should therefore make proper provision for the supervision of wholesale intermediaries, including a separate wholesale insurance intermediary division to handle the supervision of Lloyd's brokers and other wholesale intermediaries.

Q11. What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the FCA?

Our response to Q5 on the PRA's objectives also applies to this question. In summary:

(i) The similarity of the PRA's and FCA's objectives could give rise to overlap, particularly in relation to dual-regulated firms.

(ii) The Regulatory principles applicable to both the PRA and the FCA should include a need to have regard for UK competitiveness.

In carrying out its duties, the FCA should have regard for differentiation in types of contract. Supervision of the conduct of insurance business takes account of differences in customers and the more onerous requirements apply to contracts with private individuals only. This approach should continue and the regulatory burden on entities within Lloyd's – a wholesale market, whose customers are primarily non-UK and large commercial – should be minimised.

Q12. What are your views on the Government's proposed arrangements for governance and accountability of the FCA?

We generally agree with these proposed arrangements.

However, we note that there is no reference to the manner in which the FCA will exercise its rule-making powers. The July 2010 consultation document said this about rule-making by the CPMA (now to be the FCA) (para. 4.20):

> *"The rule-making function will be subject to statutory processes, including consultation with statutory panels, and wider public consultation. The CPMA will also be subject to the duty to carry out detailed market failure analysis and cost-benefit analysis prior to the introduction of any new rules."*

We assume that it remains the Government's intention for these requirements to apply to the FCA. We support this approach.

Q13. What are your views on the proposed new FCA product intervention power?

Product intervention by the FCA is likely to be a powerful supervisory tool, which needs to be exercised very carefully to avoid unintended damage to the financial sector. The FCA should exercise such powers only in extreme circumstances and be aware that they carry risks of harm not just to the providers of financial services but also to their customers.

We agree that the FCA must publish and consult on a set of principles governing the circumstances under which it would use this new product intervention power.

Q14. The Government would welcome specific comments on the proposed new power in relation to warning notices.

We disagree with the proposal that both the PRA and FCA be entitled to publicise the fact that a warning notice has been issued in circumstances where the outcome of the case has not been determined. This may risk unfair reputational damage to firms and individuals in the event that the enforcement action is later discontinued or unsuccessful.

However, if it is considered appropriate that the PRA and FCA should have such power then it should only be exercised in exceptional circumstances where publication is demonstrably in the public interest. The proposed safeguards that the power be discretionary, that the regulator must consider the impact of the disclosure on the firm / individual and that any discontinuation of enforcement action must also be published, are essential.

Regulatory processes and coordination

Q17. What are your views on the mechanisms and processes proposed to support effective coordination between the PRA and the FCA?

We agree that there should be a legal duty on the PRA and FCA to co-ordinate their activities and a requirement on both bodies to agree and publish a Memorandum of Understanding (MoU) setting out how they will deliver the duty. The new regime must avoid duplication of regulatory oversight.

It is important that the PRA and FCA are transparent when developing their cooperation mechanisms. They should be required to consult stakeholders when drawing up their MoU. Lloyd's unique structure creates specific supervisory challenges and it would be appropriate for the MoU explicitly to take account of Lloyd's and its oversight of the Lloyd's market.

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?

We agree that the PRA should be able to prevent the FCA from taking actions that would be likely to lead to the disorderly failure of a firm or wider financial instability.

Q19. What are your views on the proposed models for the authorisation process – which do you prefer, and why?

We do not agree with the suggestion that two separate aurthorisation processes, for "prudential" and "conduct" approval, be created. It is important to avoid the cost, complexity and bureaucracy that two separate authorisation processes would necessarily entail. We therefore support the Government's alternative approach to the authorisation process, where a single authority is responsible for processing each application, seeking consent from the other authority where appropriate.

We believe that the authority with prudential responsibility for the activity at the centre of the application should process the application. For firms in the Lloyd's market, this would be the PRA.

Q20. What are your views on the proposals on variation and removal of permissions?

We support the proposal in the consultation paper to replicate the current powers on variation and removal of permissions.

Q21. What are your views on the Government's proposals for the approved persons regime under the new regulatory architecture?

We believe that there should be joint responsibility on the part of the PRA and FCA to approve significant influence functions for dual-regulated firms, as there is a danger that giving one authority the lead on approvals for a particular function will result in an unbalanced focus on issues relevant to that regulator. It is important that the system is as efficient as possible, so candidates put forward one application only and, if appropriate, attend a joint interview.

Q22. What are your views on the Government's proposals on passporting?

We support the proposals on passporting.

Q26. What are your views on proposals for the new authorities' powers and coordination requirements attached to change of control applications and Part VII transfers?

We support the proposal for the PRA to have primary responsibility for the Part VII transfer process. It is important that there is co-ordination between the PRA and FCA and that the firm's main dialogue is through the PRA.

Q28. What are your views on the Government's proposals for the new authorities' powers in respect of fees and levies?

We support the Government's proposal that the current arrangements for the collection of fees are replicated within the new regulatory structure. Each authority will set its fees for the authorised firms it regulates and will remain subject to a consultation requirement with industry. We would encourage the authorities to be more transparent as to how cost apportionment is undertaken when fees are determined. Where the PRA is the lead supervisor, as it will be of Lloyd's, the FCA's fees should reflect its limited role.

As noted in our comments on the Impact Assessment, we are concerned that the new system will prove substantially more expensive than existing arrangements. We welcome efforts to restrict any rises in the on-going costs of financial supervision.

Compensation, dispute resolutions and financial education

Q29. What are your views on the proposed operating model, coordination arrangements and governance for the FSCS?

The new financial regulatory system makes changes to the operating model and rule-making processes of the FSCS inevitable and we agree with the approach proposed in the consultation paper. The FSCS should remain a single body and it is appropriate for the PRA to be responsible for making compensation and fees rules on insurance provision.

We note that the Government's earlier consultation on financial regulation, published in July 2010, suggested that arrangements under which the PRA and the FCA had separate rule-making powers could lead to an end in the current cross-subsidy between different classes of levy payers. This is not mentioned in the later consultation. We continue to support the ending of cross-subsidy.

The proposal that Members' Agents be supervised by the FCA may leave them open to levies on retail financial service providers by the FSCS. This would not be reasonable, as their existing FSA permissions are in essence limited to "advising on syndicate participations". All levies should be equitable and avoid cross-subsidisation.

Q30. What are your views on the proposals relating to the FOS, particularly in relation to transparency?

We do not agree that FOS should publish details of specific complaints or firms via the publication of determinations. FOS already has powers to publish complaint data for firms where FOS has received at least 30 new cases *and* resolved at least 30 cases in a six-month period. We believe that this publication of complaint data provides sufficient transparency for consumers and encourages businesses to reduce the number of unresolved complaints referred to the ombudsman service.

However, if the Government decides to allow FOS to publish determinations, it is important that FOS consults on the principles it would apply to publication.

Q31. What are your views on the proposed arrangements for strengthened accountability for the FSCS, FOS and CFEB?

We agree with the Government's proposals to make the FSCS, FOS and CFEB more accountable.

European and international issues

Q32. What are your views on the proposed arrangements for international coordination outlined in the chapter?

We welcome the proposals in the consultation paper to ensure that the UK is effectively represented in the work of the new European Supervisory Authorities. Most of the financial

regulatory rules applied by UK supervisors derive from EU Directives. It is therefore crucial that the UK has a strong and effective voice in the development of financial services regulation and supervisory issues within the new European Supervisory Authorities and other European institutions.

Impact Assessment

We have concerns about the transitional and ongoing costs that are described in the Impact Assessment attached to the consultation paper.

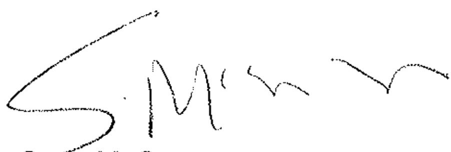
It is estimated that the transitional costs for the Governments' preferred option is £140m to £240m over two to three years. This is a substantial increase in transitional costs from the July 2010 consultation paper which put the estimate at £50m. For dual-regulated firms, the Impact Assessment assumes that 800 dual-regulated firms will incur additional costs of £60,000 on average and the remaining 900 dual-regulated firms will incur costs of £10,000 on average so the transitional costs would be £57m. The Impact Assessment states that this is a highly tentative estimate and welcomes industry comments. We believe that these transitional costs are significant underestimations.

The Impact Assessment assumes that firms will not face additional ongoing compliance costs as a result of the Governments' proposed changes. We do not agree with this assumption. We believe that dual-regulated firms will incur significant ongoing costs in dealing with two regulators instead of one, due to continued training costs, authorisation and approval costs, managing relationships with two regulators and the cost of operating two regulators.

We think that the paper's conclusion that *"...the FCA's and PRA's combined ongoing running costs should not be materially different (in real terms) in aggregate from the current FSA budget..."* is optimistic. This conclusion assumes that the PRA will be "more efficient" than the FSA and will adopt more cost-effective IT solutions, even though the PRA is expected to have "more intensive and demanding engagement" with supervised firms. It is possible that the PRA will not be more efficient than the FSA and that cost savings anticipated through IT solutions will fail to materialise.

Please do not hesitate to contact me should you have any questions on our response.

Yours sincerely



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Annex

The supervision of Lloyd's under the new regime

Summary

- We welcome the proposals for the PRA to be the lead regulator for Lloyd's as a whole, taking responsibility for prudential and organisational rules relating to Lloyd's, including the activities of ensuring the adequacy of members' resources and Lloyd's central assets.

- The PRA's supervision of Lloyd's must continue to take account of Lloyd's oversight of risk within the market.

- A new Co-operation Agreement between Lloyd's, the PRA and the FCA is necessary to ensure the avoidance of overlap and to facilitate supervision of the Lloyd's market.

- Current arrangements under the Financial Services and Markets Act 2000 (FSMA) for the supervision of Lloyd's and the authorisation of entities within the Lloyd's market should remain unchanged, except to the extent that changes are necessary to recognise the new supervisory structure.

The role of the Corporation of Lloyd's

The Council of Lloyd's has statutory powers to regulate the business of insurance at Lloyd's and Lloyd's has enforcement powers over persons working within the Lloyd's market, as does the FSA.

The Corporation of Lloyd's devotes substantial resources (at least 150 people) in its Performance Management, Risk Management and Finance areas to ensure that risk is managed across the Lloyd's market. Lloyd's Performance Management Framework sets out minimum standards which managing agents must comply with to be permitted to operate at Lloyd's. These standards go beyond the FSA minimum regulatory requirements.

Lloyd's Risk Management Framework identifies, assesses and monitors the major risks affecting the Society and the Lloyd's market. The framework includes a comprehensive risk and control assessment procedure which is conducted on an ongoing basis. This review re-assesses the existing risks and identifies new risks. It evaluates controls in terms of adequacy of performance and also seeks to monitor the action plans in place to help manage risks.

Two key controls exercised by the Corporation of Lloyd's and relevant to the prudential supervision of the Lloyd's market include:

- **Capital adequacy:** Lloyd's assesses each member's capital needs and conducts an annual solvency test at individual member and aggregate market level. Lloyd's has the ultimate power to determine the appropriate level of capital required of each member of Lloyd's.

- **Management of underwriting risk:** Lloyd's reviews and approves syndicate business plans, publishing guidelines for their preparation and monitoring syndicate performance against those plans. Without Lloyd's approval a syndicate cannot operate at Lloyd's.

It is important that the UK's supervisory structure continues to take account of Lloyd's oversight of risk in the market and its role in ensuring capital adequacy. The consultation paper states (in paragraph 3.30) that "the arrangements for cooperation and coordination between the FCA and the PRA will take account of the position of Lloyd's". We understand this to mean that the PRA's oversight of Lloyd's will continue to take account of Lloyd's statutory responsibilities and that no change is envisaged to the operational oversight of Lloyd's both by the Corporation and by the PRA and, to a lesser extent, the FCA.

The Co-operation Agreement

Lloyd's has statutory obligations under the Lloyd's Act and statutory enforcement powers over persons working within the Lloyd's market. The exercise of these powers is subject to the terms of a Co-operation Agreement between Lloyd's and the FSA, the latest version of which was entered into in August 2007. The Agreement is intended to ensure that the FSA and Lloyd's maintain an effective working relationship on authorisation, supervision and enforcement matters in respect of firms and individuals operating within Lloyd's and to ensure that duplication is minimised. The Agreement recognises that, as part of its oversight of the market, the FSA will seek to utilise Lloyd's systems and controls in respect of the monitoring of managing agents and syndicates.

As the separate rulebooks and powers of supervision and enforcement of the PRA and the FCA will apply to Lloyd's managing agents, it will be necessary to replace this Agreement. We strongly recommend that it is replaced by a single new Co-operation Agreement between Lloyd's, the PRA and the FCA. This will help to avoid regulatory overlap, facilitate supervisory co-operation and maximise the efficiency and effectiveness of supervisory and enforcement powers.

Responsibilities of the PRA and the FCA

We believe that Lloyd's interaction with the members of Lloyd's should continue to be subject to prudential supervision, rather than conduct of business supervision. It will therefore be the responsibility of the PRA.

Existing conduct of business requirements applying to insurers are contained in the FSA's Conduct of Business and Insurance Conduct of Business sourcebooks. The Conduct of Business sourcebook does not apply to Lloyd's-specific activities and the Insurance Conduct of Business sourcebook applies to managing agents as it applies to insurance companies, but does not apply to the Society of Lloyd's, as it does not conduct insurance business. Consequently, Lloyd's interaction with and protection of Lloyd's members are subject to requirements in the FSA's Prudential Sourcebook for Insurers.

This reflects the FSA's views on the most appropriate approach to Lloyd's supervision. Lloyd's relationship with, and controls over, members is bound up irrevocably with ensuring that members have adequate capital to pay valid claims, the key prudential consideration. All such activity is supervised by the FSA's Lloyd's Market Supervision team, which we understand will transfer to work within the PRA. It would be sensible for it to continue with its existing responsibilities, firstly, because of its familiarity with Lloyd's operations and infrastructure, secondly because an alternative approach – that Lloyd's interaction with members is predominantly a conduct of business matter – would require a fundamental reappraisal of supervisory approaches, combined with a re-writing of regulations and the establishment of a properly-trained Lloyd's team in the FCA, duplicating the Lloyd's team in the PRA. Any split

between the FCA and the PRA of oversight of Lloyd's relations with members will risk confusion, duplication, overlap and discontinuity.

An activity which should continue to be supervised by Lloyd's Market Supervision team in its new role as part of the PRA is capacity transfer. There is an organised process for this, the rules for which appear in the FSA's Prudential sourcebook for insurers (INSPRU Rule 8.4 (*the Capacity Transfer Market*)). These rules apply to "any method of transferring capacity in syndicates, including capacity auctions, bilateral arrangements, capacity offers, minority buy-outs and conversion schemes." The appearance of these rules in INSPRU reflects the FSA's judgement that they naturally form part of the prudential regulation of the Lloyd's market and so should form part of the PRA's responsibilities. Capacity transfer does not involve the day-to-day conduct of Lloyd's in dealing with its customers and clients, so is not supervised under conduct of business rules.

We consider that the FCA supervision of the Lloyd's market will focus on the protection of policyholders purchasing insurance contracts arranged within the Lloyd's market. Membership of Lloyd's will be subject to prudential supervision by the PRA, which will provide oversight of Lloyd's controls. The FCA's interaction with the Society of Lloyd's will therefore be limited.

Lloyd's members' agents

We are aware of the case made to you by Hampden (a Lloyd's members' agent) and we support their arguments for Lloyd's members' agents to be regulated by the PRA. There are only three members' agents and the FSA views members' agents as "low risk". Members' agents' primary activity of advising members on Lloyd's participation – with its connotations for the syndicates they join and the capital they provide – is considered to be ancillary to Lloyd's prudential oversight and so members' agents are supervised alongside other elements of the Lloyd's market in the FSA's Wholesale Insurance section.

Prudential oversight of three members' agents by the FCA would have no affinity with the FCA's other tasks and would require the FCA to develop its own centre of expertise, which would not be efficient or economic. It is our belief that members' agents should be supervised by the PRA and not be subject to FCA prudential oversight.

Authorisation of Lloyd's entities

Lloyd's unique structure means that it does not fit neatly into the system of authorisation set out in FSMA. Consequently, FSMA s. 315 contains special provisions for the authorisation of the Society of Lloyd's and s. 316 does not require Lloyd's members to be authorised persons unless "the Authority" (who we assume will be the PRA going forward) directs. We strongly support the continuation of these provisions, with modifications only made where this is necessary to reflect the new supervisory bodies.

Authorisation of Lloyd's members is subject to Lloyd's own processes, which are subject to supervisory oversight. As Lloyd's has over 2,000 members, the task of authorising them all, as well as new applicants, would be a substantial additional task for any new authority, which would not contribute to achieving the authority's objectives.

Conclusion

Existing arrangements for the supervision of Lloyd's recognise its particular structure and trading arrangements and have enabled the Lloyd's market to trade successfully over the period since the FSA assumed its responsibilities for regulation of Lloyd's in 2001. During this period Lloyd's has significantly increased its financial resources, as well as its annual premium income and is in a stronger financial position than at any previous time.

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Financial Regulation Strategy
HM Treasury
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By email to: financial.reform@hmtreasury.gsi.gov.uk

Dear Sirs

Treasury Paper - A new approach to financial regulation: building a stronger system - February 2011

LMA introduction

The Lloyd's Market Association (LMA) represents all the managing agents at Lloyd's, which manage the syndicates underwriting in the market, and also the members' agents, which act for third party capital. The Lloyd's market premium capacity for 2011 is £23.2 billion.

Whilst this response is distilled from the views of our members, the views of individual members may differ.

Paragraph references below are to the February 2011 HM Treasury paper. The appendix contains answers to a number of consultation questions.

Key points for further consultation

The LMA recognises the need for strong regulation in the UK financial services sector and it is essential that this should work to increase market efficiency. We appreciate the opportunity to respond to the Government's proposals. We also appreciate the specific reference to the insurance sector in the consultation and to Lloyd's in particular. We note that the Government, Bank and FSA will continue to consider how the characteristics of insurance firms should be recognised in the new framework [Para 3.22]. In this context, we would like to make the following high level points:

- We see the Memoranda of Understanding (MoU) between the PRA and FCA as crucial documents and we would ask that the LMA be consulted through the Corporation of Lloyd's on these in relation to the supervision of the London insurance market, as well as in the development of MoU between both the PRA and the FCA and Lloyd's corporation.

- We believe that it is crucial that the general insurance sector is fully represented within the FPC and the PRA and FCA at board level by senior people with direct experience in the insurance business; and that the general insurance teams in both the PRA and FCA employ personnel who have expert knowledge of the insurance market.

- We would encourage participation of insurance practitioners in the development of the PRA and FCA rulebooks, including the incorporation of the Solvency II framework and, in due course, the revised Insurance Mediation Directive (IMD2) into the UK regime. The LMA would be willing to identify suitably experienced practitioners, if requested.

Key points raised in response to the July 2010 consultation

We raised a number of concerns in our letter of 10 September 2010, responding to your consultation paper of July 2010. These included:

- the proposed regulatory structure was bank-centric and that for the general insurance industry it appeared over-engineered and is likely to be overly costly;
- the structure could give rise to "overlap", there was a danger of "underlap", and that potentially there could be a lack of consistency between the new authorities;
- Lloyd's managing agencies would face supervision by three statutory regulators in the UK if the FCA were to be involved in the regulation of the market, i.e. by the PRA, the then-named CPMA, and Lloyd's corporation in-so-far as it exercises powers as a statutory regulator, with resultant costs burden;
- the timetable for bringing the new structure into being ran with other major EU initiatives, namely Solvency II, IMD2 and the establishment of EIOPA and we were concerned that attention would be deflected from negotiations in the EU and that resources of experts would be spread thinly.

We understand the Government recognises all of these problems but they remain of concern.

February 2011 Consultation

(1) Memoranda of Understanding

The current consultation contains three specific paragraphs on Lloyd's [Paras 3.28, 3.29 and 3.30]. The Government proposes that the Society and managing agents be dual-regulated firms and members' agents and advisers and Lloyd's brokers should be FCA-regulated firms.

We note that Para 3.30 says that the arrangements for cooperation and coordination between the FCA and PRA will take account of the position of Lloyd's. We see these arrangements as vital to the efficiency of the new structure and competitiveness of the Lloyd's market. We ask that:

- MoU also be drawn up between Lloyd's corporation and the PRA and FCA, as well as between the PRA and FCA, and that the LMA be consulted through Lloyd's corporation in this process (the FSA and Lloyd's corporation currently have an MoU in place);
- the MoU set out the supervisory process, including the appointment of relationship managers, co-ordination of supervisory visits and co-ordination of requests for information and documentation;
- the MoU deal with the regulation of service companies (intermediaries owned within managing agency groups) and specifically whether these companies will be able to remain appointed agents of managing agents or whether they will have to become authorised in their own right by the FCA - many service companies operate within the permissions of the related managing agent and separate authorisation would be an additional burden;
- the MoU deal with supervision issues where a managing agency is related to a UK insurance company or overseas insurance company with a UK branch, and may even operate from the same offices;
- the MoU deal with the efficient regulation of members' agents and the syndicate capacity auction process; and,

- drawing these points together, the MoU are very clear on where one regulator can rely on another in relation to normal supervision of the Lloyd's market, including the reliance that the PRA and FCA will put on Lloyd's corporation in relation to prudential supervision and conduct of business regulation of managing and members' agents and service companies; and the reliance the FCA may put on the PRA in relation to any conduct of business matters.

In relation to the last point,

- Solvency II implementation for the Lloyd's market will be all-important in respect of the PRA-Lloyd's and PRA-managing agent interface;

- Lloyd's comprehensive minimum standards and Franchise Board supervision should have a bearing on the level of FCA-managing agency interaction: for example, perhaps this could be thematic rather than relationship managed with each managing agency;

- since members' agents may represent just 3 out of some 20,000 FCA-regulated firms in their specialist area, we believe they should be supervised primarily by the "Lloyd's team" at the PRA and, in relation to FCA supervision, reliance could be put on Lloyd's corporation for their conduct regulation, and the regulation of the capacity auction process, with normal FCA interface at Lloyd' corporation level.

(2) Overlap, underlap and costs

We remain concerned that

- overall staffing levels of the PRA and FCA relating to managing agents, members' agents and service companies will increase from present FSA levels and therefore fees and levies will increase (noting that managing agents and members of Lloyd's are also levied by Lloyd's corporation);

- in the shift to the new structure, the PRA and FCA will lose expertise in the Lloyd's market which has been built up over ten years by the FSA or, for example, if the majority of the Lloyd's team at the FSA move to the PRA, the FCA will be left with little expertise in respect of managing agents, service companies and members' agents;

- there will be lack of consistency and duplication in relation to authorisations and approvals which will be time-consuming to resolve in relation to individual applications;

- the standing costs of each authority, which will have to be paid for by fees and levies, will be significant if each has its own authorisations and enforcement arms, as proposed;

- interactions between managing agents' staff and the two new authorities will be more time-consuming and costly than with the FSA;

- in ensuring that their own objectives are met, and that "underlap" does not occur, duplication between PRA and FCA will be inevitable whatever MoU arrangements are put in place;

- the costs of transition will be much higher than estimated by the Treasury in the Impact Assessment, because: two new handbooks will have to be created for the PRA and FCA; and familiarisation of staff with these and associated training costs, and involvement in consultations on the new rules, will be more time-consuming than envisaged.

We asked in our response of 10 September 2010 that the Impact Assessment be extended to cover these points but note that the new analysis in the current consultation does not deal specifically with this. We see the MoU, and in particular the reliance which will be placed on Lloyd's corporation for normal conduct regulation, as important factors in minimising these potential problems.

(3) European initiatives

This consultation contains passing reference to Solvency II [e.g. Box 7.B] and no substantial reference to IMD2. How these Directives and associated regulations of EIOPA are mapped to the PRA and FCA rulebooks is vitally important.

We remain concerned that

- in managing the change to the new UK structure, the Government, Bank and FSA will inevitably have less time and expertise to devote to Europe and the shape of the new Directives;
- the mismatch between the proposed UK structure and EU structure will mean that those involved in representing the UK with each new EU authority may have less hands-on experience and detailed knowledge in the particular sector or, in relation to prudential or conduct regulation (as the case may be, depending on whether their own work is "prudential" or "conduct") their voices may carry less weight - in our view the complex consultation and representation arrangements between the UK authorities, discussed in Section 7 of the consultation, will not cure the structural problem;
- given the need to reflect EU directives and regulations of the four new ESAs within the UK regime, the mismatch may make the rulebooks of both the PRA and FCA difficult to construct and complex to use - the PRA and FCA will need (i) to separate EU prudential and conduct rules and (ii) to incorporate in their own rulebooks the relevant rules of all three main sectors for which the EU will be making separate rules;
- these problems may lead to "gold-plating" of UK rules and variation from the originating directives rather than simple translation;
- where other EU members adopt a system which maps comfortably on to the EU structure, and which is sector-specific, there will be efficiencies which will put their firms at a competitive advantage to UK firms;
- EEA firms will consequently have a lower entry barrier into the UK market, in terms of regulatory applications, compliance burden and costs, than UK-based firms.

As an example, we note that the Government is proposing a tough and intrusive consumer protection regime by the FCA; but that the Treasury is supporting a far-from-tough "on request" remuneration disclosure regime for intermediaries in its recent response to the EU Commission on IMD2; and that the lead UK body represented on the responsible EU body, EIOPA, in relation to this conduct matter is not the FCA but the PRA. We would ask how the Government intends to reconcile this disparity in its approach at UK and EU level and how gold-plating of IMD2 will be avoided and regulatory arbitrage minimised?

(4) PRA and CPMA rulebooks

In addition to the possible difficulties noted above:

- We would be concerned if the rules allowed either the PRA or FCA to make an enquiry public at an early stage, because of the potential for causing loss of

reputation and commercial damage to firms and individuals where this turns out to be unjustified: we comment further on this in answer to the consultation questions in the appendix to this letter.

- In respect of the PRA in particular, which is proposed to be a judgement-led supervisor, we would be concerned about enforcement action being taken against an authorised firm or person where commercial judgment, which is not obviously contrary to any rules or regulations, is challenged only with the benefit of hindsight.

- We would make the point that the PRA will need highly experienced staff, with relevant expertise, to operate effectively as a judgement-led supervisor in the London insurance market.

- In relation to the insurance sector, we question whether the suggestion in the consultation that the PRA's rulebook will be principles-based (consistent with a judgment-led approach) is realistic [Para 3.32], since the Solvency II framework will be transposed into PRA rules on a maximum harmonisation basis. Also, part of the Solvency II regime may translate into conduct matters which the FCA would need to incorporate into its rules, adding to complexity.

(5) Centralising authorisations, enforcement and levying

- We have urged that where possible authorisations, enforcement and levying functions are centralised between the two authorities. Therefore, we appreciate the options considered in relation to authorisations and proposed centralisation of fee-raising. We comment on this in our answer to consultation questions 19 and 20 (authorisations) and 28 (fees).

- We are concerned by the proposal that both the PRA and FCA would have independent powers to specify controlled functions [Para 5.48]. We believe that they should have a duty to specify one set of controlled functions for dual-regulated firms or at least an obligation to ensure consistency where there is an overlap. For insurance, (i) these would have to be consistent with the governance requirements of Solvency II; and (ii) for smaller firms in particular, some managing agencies falling into this category, their size does not allow for an overly prescriptive and complex set of controlled functions, and this is likely to be a problem if the PRA and FCA functions are not aligned.

- In the relation to enforcement proceedings, where a case concerns both prudential and conduct matters, the potential liability of paying for two sets of prosecutors' fees for those facing regulatory enquiries could lead to injustice - for example, the pressure to settle early to mitigate this risk even when the firm or person in question believes the criticism is unjustified.

- The consultation says very little on the proposed enforcement process: we advocate that whilst each authority should be able to settle misconduct cases, when it comes to formal proceedings, one tribunal system should exist for the PRA and FCA and cases should be referred to one prosecution department.

In the Appendix to this letter we answer consultation questions which are of particular concern to our members and we make a number of comments on the new Impact Assessment.

We should be grateful if you could take into account the views and continuing concerns of the Lloyd's Market Association expressed above and in the Appendix on behalf of managing agents and members' agents at Lloyd's. We express our wish to be involved in the further detailed consultations and, in relation to the London insurance market, look forward to providing feedback on further proposals.

Yours faithfully

David Gittings
Chief Executive

Appendix

HM TREASURY - A NEW APPROACH TO FINANCIAL REGULATION - FEBRUARY 2011 CONSULTATION QUESTIONS AND ANSWERS

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

Lloyd's has run realistic disaster scenario (RDS) stress testing for approximately 15 years.

This section of the consultation concentrates on the banking sector, without mention of Solvency II. Capital requirements for the Lloyd's market will be set within the Solvency II framework.

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

See 1 above.

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

The Government proposes that the FPC has a membership of 12, being 6 executives of the Bank (including the Chief Executive of the PRA), 5 from outside the Bank (including the Chief Executive of the FCA) and 1 non voting Treasury member.

We believe it is important that at least one Bank member and at least one outside member have front-line general insurance industry experience, particularly given the fact that the Bank has not previously supervised the insurance sector (and the importance of this is recognised in Para 2.78).

We note the interim FPC does not have an experienced general insurance sector member.

In relation to the "FPC toolkit", our view is that the FPC should consult on its policy on the use of a tool and that the PRA and FCA procedural requirements (consultation and CBA) should apply when implementing the tool. Feedback from particular sectors is vital to ensure the proposals are practical, properly formulated and proportionate in terms of cost and benefit.

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

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

In relation to regulatory principle 5 [Box 3.B], we have concerns about natural justice: if each regulator (the PRA and FCA) is to publish information relating to authorised persons, or is able to require publication, this information must be correct, the persons concerned should have had an opportunity to comment and object to publication on legitimate grounds, and (as stated) publication should only take place when this advances the objectives of one or other of the regulators.

If either the PRA or FCA is negligent or reckless in the publication of information about firms or people, or about the existence of an enquiry, we would argue there should be no statutory immunity in these circumstances.

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 appreciate that the Government recognises that insurance is different from banking, that the PRA will recognise this and this is likely to lead to less intensive supervision of insurance firms than a bank [Para 3.21] (and therefore less of a regulatory costs burden and compliance workload for firms).

Managing agents

In relation to managing agents, we ask that this question is addressed: to what extent will the PRA place reliance on Lloyd's corporation as a statutory regulator in the supervision of managing agencies?

- For those managing agencies which are part of larger insurance groups, or which manage the larger syndicates at Lloyd's, we believe the agents would want direct contact with PRA supervisory staff (albeit the managing agents are not themselves the risk carriers).
- For smaller managing agencies, which do not have a related insurance company, it may be the case that the PRA would be able to rely to a greater extent on Lloyd's for routine supervision of the agency (as well as the capital requirements of the members of Lloyd's on the related syndicates), within the Solvency II framework.

Managing agency service companies

These are insurance intermediaries but they are granted underwriting authority by the managing agency in question. Therefore they "effect insurance contracts". Within the language of Para 3.20 such service companies (and any "coverholder") would be PRA-regulated. We have argued against the concept of dual-regulation for managing agents and related service companies but believe in the context of the consultation the Treasury envisages service companies would be FCA-regulated. However, this needs to be clarified.

We have raised the question as to whether the "appointed agent" system will be retained and whether a service company could remain the appointed agent of a managing agent or whether it would have to become authorised in its own right by the FCA. At present, where a service company is an appointed agent, it operates within the permissions of the related managing agent.

Members' agents

In relation to members' agents, we ask a similar question as for managing agents: to what extent will the Bank, PRA and FCA rely on Lloyd's corporation as the supervisor of the syndicate capacity auction processes; and of conduct of business with members of Lloyd's? Given the specialised nature of the market and role of the three members' agents firms, and risks posed by them, it may be more efficient if they are primarily PRA-regulated but that the usual supervisory interface is with Lloyd's corporation, including in respect of conduct of business regulation.

FSMA amendments and MoUs

We note from Para 3.30, as mentioned, that the PRA and FCA will take account of the position of Lloyd's in their cooperation and coordination arrangements. We assume that this would extend to MoUs with Lloyd's corporation. We should be grateful for the opportunity to discuss these and indeed any plans to amend FSMA in relation to Lloyd's.

Client money

In relation to Lloyd's brokers, we have a particular interest in the client money rules, since brokers hold substantial funds for managing agents, and would ask to be included in any consultation on this aspect of the new FCA rulebook.

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 have the following points:

- We question the extent to which the PRA rulebook can be based on principles, for example, where it would need to incorporate Solvency II implementing measures and technical standards.

- We are however in favour of principles-based regulation as a concept.

- We have "natural justice" concerns about a judgement-led approach to the "approved persons" regime: who will exercise these judgements? On the basis of what information? And will those refused have an opportunity to challenge the refusal based on the information held by the PRA and its reasoning?

- We believe that enforcement decisions should be appealable on the basis of a "full merits review", as currently provided for, in accordance with natural justice principles.

- If a regulator is to be judgment-led, those exercising the judgments need to be highly competent and experienced in the industry sectors in question.

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

We would advocate strongly that at least one executive and one non executive member of the PRA Board both have substantial direct experience in the general insurance sector.

Para 3.49 states that the PRA will deal only with firms that manage significant risks on their balance sheets.

- First, this will not necessarily be the case if it regulates all insurance companies and managing agencies.

- Secondly, this suggests that to reduce the regulatory burden on smaller Lloyd's managing agencies, which are not part of groups with UK insurers, the routine supervision could be delegated to Lloyd's, as suggested under Question 6 above. (We fully understand this would not be the case with agencies managing higher impact syndicates or which are part of larger UK groups.)

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

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

We agree with the proposals that the PRA should consult on proposed rules, and that this could be streamlined when implementing EU rules which have been subject to consultation. However, where the PRA proposes to gold-plated EU rules, this should be justified and the requirement to consult is important.

Where the approach is judgement-based, we believe there is rather more need for a Practitioner Panel than less - the supervisor must keep itself closely informed with industry to exercise sound judgment and feedback will be important. Therefore, we support the existence of a Practitioner Panel.

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

Please see our point under Question 5 above.

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

As for the PRA, we advocate strongly that the FCA board has at least one executive and one non executive member both with direct experience of the general insurance sector.

We agree with the proposal that the FCA has a Practitioner Panel (as does the FSA).

Box 4.E: we note it is envisaged that the FCA will be the prudential regulator for a small number of "prudentially significant" firms, and wonder to what extent the FCA will therefore have to incorporate the PRA's rulebook?

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

We have the following points:

- Where the FCA is proposed to be more interventionalist and judgment-led [Para 4.41], this will require highly experience staff.
- We would be concerned about regulatory arbitrage and gold-plating of EU regulations (e.g. IMD2).
- We are also concerned about cost implications of the proposals.
- We agree that there should be further consultation on the proposed set of principles for product intervention [Para 4.64].
- If the FCA is given powers of intervention under the Unfair Terms in Consumer Contracts Regulations 1999, as FSA has now, and uses these actively, this gives considerable ability to ensure products are fairly worded. What additional powers of intervention in relation to products would actually be required by a supervisor?

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 note that there will be safeguards to ensure unjustified reputational damage does not occur [Paras 4.76 and 4.89] to firms or individuals. Will firms and individuals have a right of redress against the FCA (and PRA) where powers are mis-used?

If either the PRA or FCA is negligent or reckless in the publication of information about firms or people, or the existence of an enquiry, we would argue there should be no statutory immunity in these circumstances.

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 would prefer to consider this in the context of the BIS consultation on the competition regime.

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.***

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

Our covering letter raises a number of continuing concerns. We note that the Bank and FSA will publish details of operating models of the PRA and FCA, within the FSA, this Spring [Para 5.2]. We would appreciate an opportunity to discuss these in relation to Lloyd's corporation, managing and members' agents and, in due course, the MoU between the regulators.

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

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

For dual-regulated managing agents, we prefer the "alternative approach" on the basis that one authority taking charge of the process is likely to be more efficient than two separate processes run by the PRA and FCA.

Given the PRA has power to veto decisions of the FCA, this would suggest that the PRA should take responsibility for processing applications in respect of managing agencies.

However, if there were to be substantial efficiency gains in the FCA running the process for all firms (and we believe this would be the case), with input from the PRA for dual-regulated firms, we would support this more efficient system.

For dedicated managing agencies (with only a Lloyd's business), we ask if Lloyd's corporation should run the process, obtaining approvals from the PRA and FCA?

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

With the two regulators, and given their roles, we agree that the PRA should have a veto.

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

It is proposed that both authorities have power to specify controlled functions with each taking the lead on the functions most relevant to the authority. We believe it is highly desirable that one set of functions is agreed by the regulators.

We question whether the proposals are workable in practice, especially for smaller managing agencies with smaller senior management and governance teams.

The system of controlled functions would need to be compatible with Solvency II governance arrangements.

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

To analyse this question in relation to managing agents, we would need more information on how service companies are to be regulated - whether they would always be FCA-approved firms in their own right or whether they may be appointed agents of dual-regulated managing agents. This would dictate the relevant UK prudential authority.

In relation to competing EEA firms with UK branches, our concern is that their regulatory and compliance costs would be lower, putting the managing agencies or their service companies at a competitive disadvantage.

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

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

25 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?***

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

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

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

We appreciate the point made [Para 5.99] that care will need to be taken in relation to fee allocations, and fee levels overall, charged to smaller dual-regulated firms, because of the potential burden. A significant number of managing agencies would fall into this category.

We agree that each authority should be required to consult on fees with industry and with each other [Para 5.100].

We agree that there should be an arrangement whereby fees are collected by one body, both on grounds of efficiency and so that the authorities and regulated firms can clearly see how much is being levied in a consolidated statement.

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

We think it is difficult to comment on the powers and responsibilities of the PRA and FCA and how these would interact without knowing the shape the Scheme will take in the future (we understand that the FSA was going to consult on this but this has been delayed). We look forward to a consultation paper on the FSCS in due course.

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

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

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

We note that in the new EU supervisory structure, the three new ESAs (EIOPA for insurance and pensions, EBA for banks and ESMA for securities and markets) will be responsible for both prudential and conduct of business supervision. From Box 7.A we note the ESAs core tasks will be: to have strong technical standard setting powers; to set a single rule book for national regulators to enforce; to ensure national supervisors comply; to settle cross border issues; and to give guidance.

We wish to make the following points:

- The PRA and FCA rulebooks will be largely driven by EIOPA, in the context of general insurance, and relevant Directives, including Solvency II and IMD2.

- A principles-based PRA rule book for the judgment-led regulator may not be a realistic proposition.

- On the accepted principle that the UK should not gold-plate EU rules (so that regulatory arbitrage does not occur), it is crucial that the negotiating effort should take place at EU level, since this will fix the shape of the PRA and FCA rules.

- The proposed UK structure will not be conducive to effective negotiating and easy transference of EU rules to UK rulebooks - in the UK the current proposals split prudential and conduct supervision for significant firms; in the EU prudential and conduct regulation is combined and the split is by financial sector.

Therefore, for example, the UK seat on EIOPA should be held by an insurance and pensions expert, who can talk to both Solvency II (prudential), IMD2 (conduct) and other insurance sector initiatives; yet it will be held by the PRA, which will be predominantly concerned with banking and will not speak for conduct issues.

There is a danger that this mismatch will give a perception of lack of UK expertise at the EIOPA table. If, for argument's sake, the UK were to have an insurance and pensions authority dealing with prudential and conduct matters, the UK member of EIOPA (and the International Association of Insurance Supervisors) would have the full strength of the UK insurance sector directly behind it.

We believe that the domestic co-operation arrangements [Paras 7.9 to 7.15] are required, including a statutory MoU between responsible bodies [Para 7.30], but given the proposed structure the arrangements will be inefficient and may not cure the perception problem.

Given the programme of change, we believe a unique opportunity to align structures in the UK with the EU and internationally is being missed. This lies behind many of the concerns set out by the LMA.

We note that the Solvency II programme, which is of fundamental significance to the insurance industry, is only referred to in the round-up paragraph of Box 7.B.

Impact Assessment - comments on transitional costs

In the "Summary: Analysis and Evidence" for Option 1 (i.e. PRA and FCA option on page 2 of the Impact Assessment) it is stated that transition costs will be £140m to £240m over 2 to 3 years for public authorities and the new regulators (development and implementation) and for regulated firms. It is assumed that firms will not incur significant ongoing costs.

In relation to transitional costs, we note that:

- the assessment has apparently increased from £50m in the July 2010 consultation to £140/240m in this consultation but without detailed explanation.

- The consultation states that Government sought views on transitional and ongoing costs in the July 2010 consultation but few respondents addressed this [Para 15 of the Impact Assessment discussion]: the LMA attempted to do so by putting this in the perspective of Solvency II development work. Lloyd's corporation now estimates that the costs for the Society and managing agents of developing and implementing Solvency II may amount to a figure in excess of £250 million. We expect that the transition to regulation by new authorities, including consultation in developing their rulebooks and training, will amount to tens of millions of pounds for the Lloyd's market (using Solvency II as a measure for the costs of significant regulatory change). This may be exacerbated by the mismatch between the proposed UK architecture and EU architecture.

The Government now estimates that of the 20,000 firms regulated under FSMA, some "2,000 will be regulated solely by the FCA" [Para 35 of the Impact Assessment - we assume there is a mistake here]. In Para 36, only transitional costs such as new stationery are mentioned, not the costs of 20,000 firms working with a developing FCA rulebook.

Para 37 says that 1,700 firms are likely to the PRA-supervised and dual-regulated. The assumption is made that these firms will be large and that the transition costs to dual-regulation in setting up systems would be a function of their size. First, this seems to be a circular argument; secondly, the size assumption does not apply to managing agents: in 2010, there were some 7 managed syndicates with gross premium capacity of less that £100m and some 26 managing agencies (of 52) managing premium capacity of around

£300m or less; thirdly, this paragraph mentions only new systems but does not discuss the costs of training and development in relation to two new rulebooks.

In Para 39 the Impact Assessment accepts that some PRA firms will be smaller but says their transition costs will be "relatively less". We believe transition costs for smaller firms would be relatively more compared to their turnover.

Para 40 says that the costs of dual-regulated firms will be "simply the costs of setting themselves up" to deal with two regulators. This seems to be an unsatisfactory basis on which to proceed to a radically different system.

Para 41 assumes that 800 dual regulated firms would incur additional coats of £60,000 on average and the remaining 900 would incur costs of £10,000 on average, so that firms' costs would be £57m. In our view this is a significant underestimation.

Impact Assessment - comments on ongoing costs

We disagree with the assumption that firms will not incur significant ongoing costs (page 2 of the Impact Assessment): we believe that dual-regulated firms will incur significant ongoing costs in dealing with two independent regulators rather than one.

In the Discussion Section of the Impact Assessment (pages 6 to 15), in Para 8, we note that: "The Bank's approach to creating the PRA is founded on a firm expectation that costs of prudential regulation will fall in the medium term. This will flow from the new judgment-based regulatory model, from improved quality of system support… from eliminating duplication between the PRA and the Bank, and also from tight control of costs".

- First, we assume that any existing duplication between Bank and FSA is in relation to the banking sector and not general insurance. Therefore, fees and levies on the general insurance sector (and managing agents) would not fall for this reason.

- Secondly, we ask how different the judgement-based model will be from the FSA's principles-based model and outcomes-based model? And, where it is necessary to reflect EU and international regulations in UK rulebooks, how realistic this assumption is?

Para 44: This suggests that ongoing costs of FCA-only firms would not rise: clearly, if regulation by the FCA is to be far more intensive, this would not be the case. Therefore, for a service company in a managing agency group, we would expect FCA-related compliance costs to increase.

Para 47: This makes the assumption that dual-regulated firms would not face additional ongoing compliance costs: based on our comments on the form the PRA rulebook is likely to take, continuing training costs, authorisation and approval costs, costs of managing the relationships and the costs of the fees to fund the separate supervisor, we suggest that the ongoing costs for firms would be significant.

There is another cost which should be calculated in the cost-benefit analysis: this relates to the risk of making a significant change to the regulatory structure rather than adapting the present comprehensive framework following the lessons learned from the financial crisis. The risk is that new gaps are opened up and that the strategy of radical change is more risky than that of adaption.

Impact assessment - comment on benefits

There is no analysis of whether the same benefits could be achieved by creating the FPC and allowing the FSA to learn from the crisis and adapt accordingly as a prudential and conduct supervisor.

There is no analysis of an alternative structure to match the EU ESA-structure.

END

Response to Consultative Paper
A New Approach to Financial Regulation: Building a Stronger System

LIIBA is the Trade Association representing Lloyd's Insurance Brokers. Lloyd's brokers generate some £1.9bn in invisible exports. London Market brokers introduce virtually all of Lloyd's business and a significant proportion of London companies business, as well as placing considerable volumes of business in International Markets. They handle in excess of £60bn of insurance premiums and claims annually. Some of our members also handle significant amounts of small/medium sized commercial, as well as, personal insurances

We understand that our sector will be regulated by the FCA which will adopt a more proactive, interventionist approach to retail conduct regulation.

While the consultative paper makes reference to the retail and wholesale financial markets, this is not necessarily recognising the differences in approach that are appropriate when dealing with larger commercial and personal customer sectors of the insurance market. We believe that it is essential that our Regulator recognises that the focus of, what was traditionally known within the FSA as wholesale firms conduct regulation, is different from that applied to retail customers. We have concerns that attention is channelled into wholesale investment markets and exchanges. It is silent on those firms involved, for example, in the wholesale insurance sector.

To this end we believe it is of fundamental importance that the composition of the FCA Board and the Rule Book adequately reflects the different issues facing the wholesale sector.

The consultative paper recognises that there is greater concern for consumers in the retail sector. On the assumption that the starting point for the FCA is the existing FSA Principles, Rules and Guidance we believe it is essential that the Treasury and FCA both reassess what constitutes a proportionate regime for the risks posed by Lloyd's Brokers handling international reinsurance and larger commercial business. Within the insurance sector large commercial business does not lend itself to systemic mis-selling. Prescriptive conduct business rules aimed at private consumers and applied to all types of customers will be very damaging to the competitive position of Lloyd's brokers. This in turn will impact Lloyd's and other major insurers operating in the London Market. Handling client money is a key feature of the regulatory regime and we are fully supportive of the need for such monies to be held in trust. The principal remaining risk

for commercial customers revolves around fulfilling any servicing obligations in the event of failure of the broker. In practice, as evidenced by the few failures which occurred pre FSA regulation, clients are very quickly absorbed by competitors who assume any outstanding service requirements. The Rules and more particularly how the Principles are interpreted by the regulator must reflect this reality, these should therefore bear some relation to potential broker failings and the regulatory approach should be centred on potential and likely outcomes. Regulation should be proportionate to the risk and reflect the different needs of private and commercial customers.

Any new rules must allow for flexibility, which is essential to meet the very different requirements/issues associated with transacting business in the London Market for multi-national global businesses, compared to the personal lines sector. We believe that rules which are most subjective rely too heavily on the ability and knowledge of each supervisor. This can result in a lack of fairness across the board. We believe that an approach based on outcomes requires FSA staff to have an understanding of a firm's business model, experience and culture to enable them to "judge firms on the likely consequences of their decisions". This requires staff to have experience of a management role, knowledge, ability and credibility among the regulated community. This is sadly not the current experience. The turnover of FSA staff within our sector has been high even though the FSA has done much to try and address this by a series of incentives.

In responding to the questions raised in the Consultative Document we have restricted our answers to those issues which are directly relevant to our sector. These are

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

We welcome the recognition that there is a need to balance proportionality against benefit. We believe that the specific characteristics of our sector need to be fully understood. To achieve this it is important that the differences between the retail and commercial markets should be recognised and accommodated.

We would welcome clarification on how the FCA believes it will be able to balance its competition mandate need alongside its primary objectives.

Competition is also a relevant issue when comparing the relative costs of regulation between Member States. Recent research has demonstrated the very significant gulf on costs faced by intermediaries in the UK when compared to all other Member States. We estimate the total of direct and indirect costs amounts to come 15% of firms profits. This is totally disproportionate to the risks imposed by the sector.

While appreciating the need for openness and disclosure, there is a real danger of causing damage in disclosing that investigations into firms are being conducted, particularly when the results of that investigation demonstrate no wrong doing.

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

We believe that proper communication between FCA and PRA is essential given the relationship between Lloyd's brokers and insurers in the Lloyd's and London Company Market and the high volume of business which is presented to London insurers by those brokers. Regulation of one sector might have a significant impact on the business of the other.

We share the belief that there should be greater transparency on how decisions are made and how these are communicated to firms and the public. There would be value in understanding what might constitute a regulatory failure.

Care should be taken to ensure that transparency will not impact too heavily on the reputation of regulated entities where no fault has been found with them.

We believe that it is essential that the designated regulator has the required knowledge and ability to identify risks and manage them if and when they arise. A strong knowledge of both consumer and commercial insurance is required.

Once again we would stress our concern that there is no "regulatory creep" which might result in a series of rules that bear no relation to potential broker failings – for example an approach centred on potential or likely outcomes, irrespective of actual outcome and detriment suffered.

It is absolutely essential that a proper and transparent assessment is conducted before any firm is regarded as "prudentially significant". The current FSA designation of firms as high impact is neither transparent nor justifiable against the risks of customer detriment.

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

There is concern that the FCA might be moving outside its role as a regulator if the FCA can take decisive action, potentially in support of retail customers in product standards, should it be empowered to regulate products/product feature without evidence of any harm. Clarity would be essential to ensure that stopping the launch of a planned or banning of an existing product was balanced and fair without any evidence of consumer detriment. There are also concerns regarding the capability of the regulator to identify such products. An example of this can be seen with PPI where, arguably, significant mis-

selling of inappropriate products continued long after the issues were identified by the Competition Authorities and the FSA.

We welcome the decision that this will not lead to product pre-approval. This should remain a management responsibility, any other approach would stifle competition and innovation.

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 have concerns that the proposed powers are far too wide. There is considerable value in transparency and disclosure but also significant harm in damaging the reputation of a firm in disclosing an investigation or complaint handling before any wrong doing has been confirmed. We believe that if the regulator provides clear guidance on what is expected from the regulated entities there should be no need to go beyond rule book compliance and enforcement to find more innovative ways to encourage good practice.

Announcing an investigation can have very serious effects on the firm itself and possibly the wider industry. In the United States there are a number of examples of this and the recent examples in the UK where the FSA's interest in Gartmore and CPP became public knowledge highlight the very significant dangers of this approach.

A notice of discontinuance is of limited value, it will receive far less press coverage than issuing a warning notice and it is not certain that it will be seen by those who have been influenced by the earlier publication of a warning. In any event by then the firm may have suffered significant commercial and reputational damage. We believe that the proposed powers might discourage firms from reporting their own regulatory failings, if these were to be disclosed in a more public forum.

The existing FSA approach of providing a detailed account of the transgression once a judgement has been arrived at is the appropriate route to follow. The current practice of publishing "Dear CEO" letters works well in terms of drawing attention to specific issues. We believe that in the past there have been failings by the FSA in making clear what is expected from its regulated entities, even after a fine has been imposed.

We agree that were there is evidence of misleading financial promotions there should be power to have these withdrawn.

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

We do not see any immediate difficulties with the FCA having a stronger role in Competition Law and await BIS's proposals with interest.

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

We would like to see some further clarification on how it is envisaged that the PRA and FCA will manage any conflicts that arise. We welcome the recognition that regulatory overlap and duplication should be managed in a proportionate way. This is particularly important for our sector where London market insurers are to be regulated by the PRA and London Market brokers will be regulated by the FCA. It will be expensive and chaotic if the regulatory requirements for insurers are incompatible with those imposed on brokers, for example, where insurers might be required to seek information from brokers, which brokers have no obligation to provide.

It is important that the "duty to coordinate" does not result in unnecessary delays or burdens on the regulated parties. We would also wish to avoid an outcome where the FCA might be minded to agree an issue which, after consultation with the PRA, was withdrawn.

The idea of a Memorandum of Understanding between the bodies would be welcomed.
Proper co-ordination between the PRA and FCA is also vital within a European context and especially so where , for example, the IMD/intermediaries regulation fall under EIOPA (and hence the PRA's remit)

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 would like to see greater clarity on this proposal, which might otherwise cause confusion and delays. In any event we believe that it should only have power of veto on wider financial instability and not disorderly failure of a firm.

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

We have no objections to the proposed models for the authorisation process, as long as they do not cause unnecessary delays and are transparent.

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

We have no objections to 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?

We have no objections to the Government's proposals for the approved persons regime

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

We are supportive as far as the FCA's role in passporting is concerned. Passporting rules for our sector should be simplified as recognised in the CEIOPS evidence to the European Commission relative to the IMD.

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

Good consultation between the PRA and FCA is an essential part of rule making and the ongoing supervisory processes.

We believe that rule waivers should properly sit under the regulatory authority responsible for that firm or group to which the waiver will apply. The criteria for refusing a waiver should be clearly stated and understood by all parties and should perhaps the PRA be minded to object to a waiver granted by the FCA then the reasons for that should be transparent with an opportunity to appeal against that decision given.

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 do not believe that the regulator should have a power of direction over an entity which itself is not regulated. This appears to extend the powers of the regulator far in excess of its statutory limits. We do not believe that the proposed safeguards are adequate to address the wide discretion the FCA would have in deciding what action is desirable for the purposes of fulfilling its statutory objective.

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

We have no comment to make on the Government's proposals for the new regulatory authorities' powers and roles in insolvency proceedings.

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

We believe there would be economies of scale if only one organisation is responsible for collection of fees

We believe that fees for our sector are currently too high and disproportionate to those levied in the rest of the EU. .

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

We believe that well-functioning co-ordination mechanisms between the FCA and PRA are fundamental. Transparency and accountability will be important. We support a statutory basis for MoUs.

Currently the FSCS is structured such that there is the potential for cross subsidy both within the five pools and across the Financial Services industry as a whole. With different regulatory bodies setting their own rules it would be inappropriate to retain cross subsidy when one regulator could design a scheme without regard to the impact on the other sectors.

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

We believe there is a tension between the open and transparent approach to rule making adopted by the FSA and the ability of FOS to make judgement which have wide application across the sector.

Transparency is an important consideration. We look forward to the consultation paper on the publication of determinations.

It is important to keep the costs of having a complaint reviewed by the FOS as low as possible, especially where complaints are considered to be unfounded.

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

The European Supervisory Authorities (ESAs) and from our standpoint EIOPA will, over time, assume an even greater influence over the rules that are applied and the approach

to supervision adopted by individual Member States. It is therefore vital that the UK plays a full and active role in the ESAs. The structures of the ESAs do not mirror the twin peaks approach proposed by the Government. In particular, EIOPA is responsible for both prudential and conduct regulation of insurers and insurance intermediaries. It is essential that there is proper co-ordination and representation from FCA on the relevant committees and working groups within EIOPA.

The same comments apply to the wider international bodies and in particular to the IAIS which sets standards for both insurers and intermediaries. We are very concerned that this aspect has not been properly recognised and addressed in the current proposals.

11.4.11

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Submission to UK Treasury Consultation, *A new approach to financial regulation: building a stronger system*

This paper, prepared for London Mining Network by Nostromo Research, is being submitted to the UK Treasury's consultation on the proposed new securities regulatory framework. However, London Mining Network regrets that this consultation officially closes on 14 April 2011. We agree with the Treasury Select Committee, which points out that, by limiting the consultation period to eight weeks, the Government is in breach of its own Code of Practice, which stipulates a consultation period of at least twelve weeks, "with consideration given to longer timescales where feasible and sensible."

Our primary concern is with the conduct of mining and minerals companies that are listed, or are expected to be listed in the near future, on the London Stock Exchange (LSE). We believe our findings are directly relevant to current discussions on the nature of future securities regulation. We believe that insufficient oversight has been exercised over the conduct of these companies and that whatever structures replace the current regulatory system, much stricter oversight must be exercised over the behaviour of mining companies listed in London.

Two major IPOs (Initial Public Offerings) by such companies are likely to be made on the London Stock Exchange over coming weeks: that of Bumi plc and of Glencore, the world"s biggest international commodities trader. Full details of these offerings are not currently available. An extension of the consultation period (to mid May) would have enabled us to make more informed comments on the serious and potentially negative implications of admitting these two companies to trading on the LSE under current UK Listing Authority (UKLA) standards.

Notwithstanding this, the following submission summarises our serious concerns in relation to several mining companies which have recently been accepted for trading on the London Stock Exchange Main or Alternative Investment Market (AIM).

Our arguments will be developed at greater length, with the presentation of additional case histories, in a report to be published by London Mining Network and The Cornerhouse in late May 2011.

Why reform of UKLA Listing Rules is vital to good regulation: with a focus on the mining/ minerals sector

In March, several environmental NGOs called on the Hong Kong stock exchange (HKx) to ensure that China"s leading gold-copper mining company, Zijin, "come clean" and fully disclose "material risks associated with one of its most controversial overseas projects, the Rio Blanco Mine in Peru," which it had taken over in 2007.

The group went on to claim that, because of this project: "[P]eople have lost their lives, and the fragile ecosystem and waterways of the Piura region are being threatened by pollution…This has not only affected the health and lives of the people, but also economic activities such as eco-tourism, agro-industry and organic farming, which are the main sources of sustainable development in the region."

The letter also raised concerns that "Zijin investors are in the dark about the risks" posed by the mine, "including the company"s failure to obtain community authorisation before beginning mining

activities, as required by Peruvian law" and "lack of compliance with Peruvian environmental regulations."[1]

This initiative followed closely on the heels of China‟s worst gold mine tailings (waste) disaster of 2010, for which the same company, Zijin, was responsible. In this case, Chinese environmental groups themselves had already urged the Hong Kong Stock Exchange to ensure the company properly report the financial implications of the spill, and Zijin‟s trading on the Exchange had already been halted several times, in advance of announcements of fines and penalties associated with the event.

Indeed, the company was de-listed for a short period last month (March 2011) after Zijin contended that two of its subsidiaries should in fact be held responsible for an "incident" which caused the deaths of 22 people and the destruction of 523 homes in the south eastern province of Guangdong.[2]

How is this sorry saga relevant to a public discussion on the re-organisation of financial regulations, taking place in a country five thousand miles away from Hong Kong?

First: because Zijin‟s Rio Blanco mine in Peru is technically owned by a UK-registered company, Monterrico Metals plc; and the most serious human rights abuses committed during its operations were made when Monterrico was firmly under British control, soon after it was accepted for listing on the London Stock Exchange in 2005.

Second: because, although assuredly guilty of causing huge harm in its home country of China (and it has already been fined US$1.4 million for the Guangdong disaster) Zijin has tended to be somewhat more circumspect in its obligations to people and the environment in Peru than its predecessor management – and arguably more open too.

A high-level UK investigation of the Rio Blanco project, reporting in March 2007, found that Monterrico Metals, when in British hands, had made several inaccurate statements, especially in claiming overwhelming support for the project from local people. But, just last week, the Chinese chairman of the company admitted that the mine had still not secured the two thirds community consent required for it to operate according to the law.

Third – and most relevant to our submission – because the Hong Kong Stock Exchange requires that minerals companies comply with specific listing requirements that have no parallel as yet with those imposed by the UKLA.[3]

Importantly these include disclosure of:

- environmental, social, and health and safety issues;
- any non-governmental organisation impact on sustainability of mineral and/or exploration projects;
- any claims that may exist over the land on which exploration or mining activity is being carried out, including any ancestral or native claims;
- [a company‟s] historical experience of dealing with concerns of local governments and communities on the sites of its mines and exploration properties.

It is no accident that the Hong Kong stock exchange imposes specific pre-listing conditions on mining and mineral companies. These firms may be no more vulnerable to corrupt practices by unscrupulous principals (directors and senior staff) than any other sector, although such

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[1] *Groups Call on Hong Kong Exchange to Ensure Zijin Mining Comes Clean about Overseas Investment Risks*, 3 March 2011. See: http://www.foe.org/sites/default/files/Letter%20to%20HKSE%20re_Zijin.pdf
[2] Reuters, 15 March 2011; Bloomberg 14 March 2011
[3] See: *A Guide to listing on the London Stock Exchange*, published by the, London Stock Exchange; accessed 10 April 2011: http://www.londonstockexchange.com/home/guide-to-listing.pdf.

propensities must certainly not be discounted. (We raise some related concerns in our study of Brinkley Mining, which follows.)[4]

However, extractive companies are much more likely (than banks, retail or services companies, for example) to be directly responsible for significant environmental violations – including the release of highly toxic metals, chemicals and gases which can have serious impacts on thousands of citizens. While global mining companies may consider themselves bound to report on a number of benchmarks, in particular those set by the Global Reporting Initiative (GRI), the majority of mid-cap or small-cap mining companies, whether listed on AIM or on the LSE Main Exchange, do not.[5] We may also cite several initiatives of the past ten years which relate predominantly to activities of the minerals sector, such as the EITI, the US Dodd-Frank Act, the Kimberley Process (regarding "conflict" diamonds), the findings of the World"s Bank"s Extractive Industries Review and others.

There is a remarkable "weighting" of "dedicated" mining companies listed in London. Nonetheless, little or no special consideration of the unique capacity of mining companies to "do harm" has been paid by the Financial Services Authority since its inauguration in 1997; nor reflected in the due diligence and special procedures (and launch prospectuses) required before these enterprises are listed on the London Stock Exchange. The FSA may claim that regulatory standards on the Main exchange are unrivalled, but many would find this scarcely credible; and it certainly does not apply to the markedly lower bar set for listing on the Alternative Investment Market (AIM), for standard (secondary) listings on the main exchange, or for companies domiciled overseas which are also able to raise capital in London.

The compliance requirements set by other agencies (such as the World Bank/IFC, or even under the weaker Equator Principles, to which a large number of banks have signed on) are continually breached by UK-based mining outfits, with little or no record of such breaches being posted under existing rules.

It might be argued that the UK government now has its hands full, simply to prevent future financial disasters of the post-2008 ilk; let others take cognisance of, and publicise, other alleged transgressions by non-financial corporates. This is, we submit, both a flawed and unacceptable thesis.

Flawed – because the risks posed by investing in what is, by its nature, a notoriously cyclical sector, are risks also directly related to the performance of the players in the sector. For example, an extra year added to a mine development plan because of resistance to it by a local community or a change of government, can bring a company down (see for example, the Brinkley case study below). When an international campaign is launched against a particular project, investors (and not only "ethical" ones) need to be forewarned as to its possible consequences; otherwise they could fail to fulfil their fiduciary duty to their own clients.

The thesis is unacceptable because, although investment institutions regularly – and increasingly – employ external agencies to make social and environmental assessments of a company"s performance and the risks posed by its projects "pipeline", the most substantial such information often derives from non-governmental organisations, and to a lesser extent journalists. (For example, in the case of African Barrick"s operations in Tanzania – see below). However, these

[4] It should, however, be noted that Richard Ralph, the former chair of Monterrico Metals, was found guilty of insider trading in Zijin shares; that Rusal, which has managed to list in Hong Kong, would no doubt have been able to list in London by now were it not for an ongoing UK High Court case of alleged fraud committed by its main shareholder, Oleg Deripaska; and one of the most prominent bribery trials in the past two years resulted in the imprisonment of four Rio Tinto staff in Beijing (they were sacked by the company, which curiously maintained that an internal investigation acquitted Rio Tinto itself of any wrongdoing).

[5] This does not mean that the big global mining companies – many of which are listed on the LSE Main Exchange – manage to keep to the guidelines. In its 2010 Annual Report, the world"s third largest mining company, Rio Tinto, admits to several "serious" breaches. Curiously, it also mentioned, for the first time, the fact that the Norwegian Government had disinvested from Rio Tinto in 2008 on the grounds of the company"s complicity in grave environmental and human rights abuses at the Grasberg copper-gold mine in West Papua.

groups and individuals are customarily severely under-resourced and their lobbying power is miniscule in comparison to the companies they may be criticising.

While NGO reports are available to investors, they are customarily ignored or considered to be biased. For example, investors such as Citigroup noted between 2004 and 2008 that Vedanta"s Nyamgiri mining proposal, in Orissa, posed a certain risk, but the underlying assumption was that it would eventually be permitted because of the reputation enjoyed by the company in both the UK and India itself. Protests made against this project by local people around the mine site itself were ignored, as were three suits against Vedanta before a committee of India"s Supreme Court. It was thanks only to the relentless continuation of the campaign in India between 2005 and 2010, assisted by the Norwegian Finance Ministry"s decision to de-list Vedanta from its Sovereign Wealth Fund portfolio in 2007, followed by UK-based Survival International"s success in bringing a complaint before the UK National Contact Point under the OECD complaints mechanism, and a detailed examination of the impacts of the company"s existing alumina refinery by Amnesty International in early 2010, that this issue became high-profile, leading to the cancellation of the mining project by India"s Ministry of Environment and Forests in mid-2010.

Thus, we assert that civil society organisations alone should not be burdened with the responsibility for determining whether UK-listed companies violate, or are complicit in violating, standards of human rights set by the UN Declaration on Human Rights and its associated protocols; or benchmark standards of environmental protection set by the use of “best available” technology to mitigate damages; and practices which jeopardise the “precautionary principle”.

The UK Companies Act of 2006 sought to clarify the duties of company directors in divulging, *inter alia*, the impacts of their company"s operations on the community and the environment – thus (in theory) leading to the abatement of the worst such activities. But, as pointed out in a March 2011 assessment of the implementation of the Act carried out by the Corporate Responsibility Coalition (CORE), this obligation is embedded in the concept of creating “enlightened shareholder value (ESV).”

And the UK government has interpreted this term as excusing company directors from taking any decision, which may indeed be in the interest of communities or “the environment”, that the directors consider not to be “in the interests of their own shareholders.“[6]

But consider who actually controls the equity of some key (and badly performing) mining companies, and this concept proves decidedly hollow.

Take Vedanta, majority-owned by just one man and his family; or ENRC, majority owned by three oligarchs, Alexander Machkevich, Patokh Chodiev and Alijan Ibragimov, and the Government of Kazakhstan, a despotic regime. Then there"s Archipelago Resources, majority owned by a business conglomerate registered in Indonesia; and finally, Bumi Resources (scheduled to present its listing prospectus on or around 28 April) which is in the clutches of one of Indonesia"s richest families – members of which were last year found guilty of serious fraud.

[6] See: *Directors, Human Rights & The Companies Act: Is the new law any different?* by Hannah Ellis and Kate Hodgson, CORE, London, 18 March 2011

Case Studies

AFRICAN BARRICK

Barrick Gold of Canada is the world"s biggest producer of the metal in terms of mined production. Its four main Tanzanian mining operations were "spun off" by the company in March 2010 when it launched African Barrick Gold (ABG) through an IPO on the London Stock Exchange. Barrick currently holds 43% of ABG as its principle shareholder.

Some analysts saw the IPO as an "attempt by Barrick to reduce portfolio risk" – (with one analyst judging it "a marketing thing" – what else, one wonders, was it supposed to be?)[7] and ABG"s entry on the London market did not exactly ring the bells of Bow.

Within nine months, the company suffered what Numis Securities called "two false starts" and, by October 2010, its share price fell by almost 10%.[8] The redoubtable hedge fund manager, David Einhorn, had disposed of his stake in ABG by January 2011, declaring that only the rising price of gold "prevented an even worse outcome."[9]

The company blamed this lacklustre performance mainly on the theft of fuel, intended for trucks and mining equipment at one of its four mines[10]. The impression it conveyed was that such events were all too likely in a country like Tanzania. Barrick spoke of "criminal fuel-theft syndicates" which had "widely infiltrated our mining department."[11]

Such a statement belied the reality that Barrick had actually become the most significant mining company in Tanzania and its operations had attracted more criticism from both domestic and external human rights organisations than any other extractive enterprise.

In June 2009, a report presented to the Christian Council of Tanzania (CCT), and researched by a team headed by Dr Mkabwa Manoko of the University of Dar es Salaam"s Department of Botany, concluded that nickel, cadmium, lead and chromium levels in water sediment and soil samples taken from the vicinity of Barrick"s North Mara mine were higher than standards set by the WHO and the Tanzanian and US Environmental Protection Agencies, and (in the case of nickel, lead and chromium in water) had become much higher than when observed in 2002.[12]

The report followed an alleged poisonous leak from the mine which local people claimed had killed their cattle, and even some people. A number of Tanzanian human rights organisations called for the mine to be closed until an independent enquiry could be held, while Barrick dismissed the accusations out of hand.

No independent enquiry has yet been organised; nor has Barrick called for one.

It may be that parent company Barrick, back in Canada, considered the launch of ABG would align its Tanzanian interests more closely with those of Tanzanzia"s business elite, thus reducing its reputational risk. In March 2011, Bloomberg reported a board member of the Dar es Salaam stock exchange saying that ABG planned to start trading shares on the east African bourse later this year[13].

What may be strongly doubted is that the FSA took much – if any – account of the fact that the Norwegian Government Pension Fund, on the recommendation of its Council on Ethics had – just

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[7] *Financial Times*, 19 February 2010
[8] *Financial Times*, 15 October 2010
[9] Foster Wheeler, 20 January 2011
[10] *Financial Times*, 15 October 2010
[11] *Financial Times*, 15 October 2010
[12] See; Levels of Heavy Metals and Cyanide in Soil, Sediment and Water from the Vicinity of North Mara Gold Mine in Tarime District, Tanzania by Manfred F Bitala, Charles Kweyunga and Mkabwa LK Manoko.
[13] Bloomberg, 8 March 2011

a year before the North Mara pollution accusations surfaced – thrown Barrick Gold out of its investment "universe". This was due to the company itself posing "an unacceptable risk of contribution to ongoing and future environmental damage."[14]

It is true that the investigations giving rise to this decision had centred around Barrick‟s operations at its Porgera mine in Papua New Guinea. Evidence of alleged major environmental violations at the company‟s North Mara operations was not available to the Council at this time. But the Council‟s conclusion (and this is a hallmark of the thorough investigatory process it has adopted) applied not only to how the company operated in Papua New Guinea, but also to its overall *modus operandi* and the nature of the in-house checks and balances it employs.

Just nine months after ABG‟s London listing, further evidence emerged that cast strong doubts on its observance of basic human rights around its North Mara operations, reflected in an unusually harsh critique of the company‟s operations at this mine published by Bloomberg journalist, Cam Simpson, at the end of last year.[15] Says Simpson: "At least seven people have been killed in clashes with security forces at the mine in the past two years", according to 28 people who were interviewed for the news service. "In at least four cases, police acknowledged the shootings in contemporaneous press accounts", says Simpson, while Barrick company documents showed that it "pay[s] the Tanzanian government for federal police protection at the mine and employ[s] private armed guards".

Barrick had acknowledged deaths at the North Mara mine during 2008 in the 486-page ABG IPO Prospectus of 19 March 2009, where the company stated that: "In some cases, those involved in security incidents have been injured, sometimes fatally."

However, the company has never admitted any responsibility for such injuries or deaths. On 19 November 2010, Barrick announced it had joined an international group of extractive companies, governments and non-profits that promotes voluntary standards to foster human rights in security operations.

These "Voluntary Principles on Security and Human Rights" include one which recommends that companies should report credible allegations of human rights abuses by public security forces to the appropriate authorities. Andrew Wray, head of "investor relations" for African Barrick, told Cam Simpson that his company "will make a formal request to the regional police commissioner's office for an investigation if it's made aware of allegations of abuse".

Nonetheless, says Simpson, ABG "mentioned no violence at the mine in reports describing its social-responsibility record on community relations, health and safety for 2009 and 2010". Last year's report simply stated: "At Barrick, we are committed to making a positive difference in the communities in which we work."

In a 21 December 2010 written response to questions posed by Bloomberg, Wray also said that "ABG categorically refutes any claim that any persons injured or killed were artisanal or small scale miners" (As if this justified state shooting of citizens who did not fall into this category). But Wray "decline[d] to comment on specific cases, citing active or potential police investigations, except for one. He said allegations that mine security inflicted lethal injuries in that instance are „fundamentally untrue." They were the result of a fight between intruders over stolen ore."

In the space of just over a year, this UK company, an associate of one of the most powerful mining corporations on earth, has had a great deal to answer for. First it has neglected to take seriously allegations of major failures at its largest Tanzanian project, leading to the poisoning of people and animals. Second, it is accused of effectively just standing by, while "security" forces guarding its assets kill and injure at will those claimed to be sabotaging the company‟s operations.

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[14] See: http://www.regjeringen.no/upload/FIN/etikk/recommendation_barrick.pdf.

[15] See: *Shooting Gold Diggers at Barrick African Mine Coincides With Record Prices* by Cam Simpson, Bloomberg, 23 December 2010; also an accompanying video at: http://www.bloomberg.com/video/65489136/

In neither case has African Barrick joined calls for an independent enquiry; nor has the Financial Services authority in the company‟s registered domain of the United Kingdom seen fit to demand one.

GEM DIAMONDS

No company would survive for long on the London Stock Exchange if it mined or traded in “blood” diamonds, specifically from Africa. The Kimberley Process and its certification scheme is intended to put paid to all that.

However, it seems reasonable to extend the definition of “conflict diamonds” to include situations where the extraction of gems (and arguably any other mineral) may lead to an egregious abuse of human rights – including an Indigenous People‟s right to occupy its own territory and benefit from the vital resources (including food and water) in it.[16]

Gem Diamonds Ltd is a full-status FTSE 250, FTSE and FTSE All Share listed company, with its head office in prestigious Eaton Gate, London SW1. But its registered office for tax purposes is in the British Virgin Islands tax haven. Because of this (and as pointed out in the case of African Minerals Ltd, *qv*), a prospective UK investor will find – for example when searching for financial information on the company by using Hemscott‟s premium investors services – that “not all fields of data are available at this time”.

The force behind Gem Diamonds is Clifford Elphick, a South-African born former “fixer” for the diamond trading empire of De Beers, who set up his own company in 2005 in South Africa, launching it on the LSE in 2007. Currently it owns operating mines in Angola, Central African Republic, Australia and Lesotho.

Another mine, Cempaka, in South Kalimantan province, Indonesia, has been on a “care and maintenance” basis since early 2009. In September 2008, the mine had been closed for four months when the provincial government raised concerns about waste water discharges from the mine. Although the company denied the allegation, it nonetheless revised its environmental management plan and re-worked a feasibility study, following which it gained government approval to re-start.

PT Galuh Cempaka was one of six Indonesian-based companies which gained approval from the Indonesian House of Representatives in October 2002 to mine in protected forest areas, despite their previously being excluded from mining under a hard-won forestry protection law of 1999.[17] Although Cempaka, at that time, was majority-owned by BDI Mining (BDIM), another AIM-listed company (now defunct) and BDIM was not taken over by Gem Diamonds until 2007, Indonesian NGOs have continued to deplore the contribution to degradation of Kalimantan‟s forestry made by this and other projects. As of now, Gem Diamonds has not surrendered its Cempaka lease.

In January 2011, Gem Diamonds was awarded a mining licence for the Gope diamond project in Botswana – a diamond field said to be worth around US$3.3 billion.[18] This is the diadem in its crown.

What renders this project “political dynamite” – and, we would argue, merits its being classified as a potential “conflict” mine – is the contention, widely broadcast by the UK Tribal Rights organisation, Survival International, that Gem will be extracting diamonds from the Central Kalahari

[16] It is relevant to point out that, late last year, 50 jewellers with more than £3.5 billion in annual sales pledged not to source gold from Anglo American plc's proposed Pebble Mine in Alaska, alleging that it threatened “the world's most important fishing grounds for wild sockeye salmon”. Noel Coyle, CEO of London firm, Fraser Hart, said: "In some areas, mining of precious metals presents too great a risk to communities and the environment. Bristol Bay is such an area." [ENS, 4 November 2010].

[17] *Jakarta Post*, 22 October 2002

[18] *Mining Weekly*, 18 January 2011

Game Reserve, from which Indigenous Bushmen have already been evicted, thus jeopardising their access to crucial traditional water holes.

In fact, the People‟s water rights to the Reserve were upheld by Botswana‟s Court of Appeal just a week after the company was given mining title to the land (an issue addressed in a discussion in the House of Lords itself in March 2011).

On announcing the award of the Gope diamond licence, Mr Elphick reportedly said: “We intend to implement sustainable solutions to the environmental and community related issues in the Central Kalahari Game Reserve to ensure that the benefits of the Gope asset are realised for the community as a whole”[19]. No reference to the specific Court of Appeal ruling was made by Mr Elphick or his company

According to Survival International‟s director, Stephen Corry, Gem Diamonds has claimed to have secured the “consent” of the Bushmen to its operation of the mine. But Mr Corry dismisses the claim, asking: “How can people who are denied water to force them out of the reserve possibly be in a position to give their free and informed consent? Particularly when no-one apart from Gem Diamonds and the government has told them what impact this massive mine might have on them?”

It should be noted that the British government is a signatory to the UN Declaration on the Rights of Indigenous Peoples, which includes the important right that these Peoples (including the Bushmen) have to proffer or withhold their “free, prior and informed consent” (FPIC) to any extractive project on their territory. In this case, this process has manifestly not been followed.

BRINKLEY MINING

Before a mining company may be admitted to trading on AIM, an independent “Competent Person” is required to assess its “trustworthiness”, by assembling a wide variety of data specific to the industry, such as on the nature, availability, grade, and economic value of a deposit; the extraction and processing technologies to be employed; the environmental implications of any particular projects; the legal status of land to be used; the issue of exploration or mining permits, *etc.*[20]

What a Competent Person need not carry out (and indeed is not usually qualified to perform) is an assessment of the wider socio-political risks a company may face, even if all the other “rooms” in its particular house appear to be in order.

In the light of what we record below, this is clearly – and to say the least – a major omission from the pre-listing process.

SRK Consulting is one of the leading international independent advisory and engineering groups which prepare Listing Particulars for mining company IPO‟s.

Among its recent reports has been a Resources Estimate, performed for African Minerals Tonkolil venture in Sierra Leone (*qv*); and an Independent Engineers‟ report which included “an…opinion of projections and cash flow forecasts” for Vedanta Resources, prior to Sterlite‟s listing of this major mining enterprise on the LSE in December 2003.

SRK also prepared a Competent Person‟s Report for Brinkley Mining‟s application to trade on AIM in May 2006, where it estimated the mineralised potential of the Waterval uranium prospect in South Africa. At the time, it was owned 49% by Brinkley through its associate company, Western Uranium.[21]

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[19] *Mining Weekly*, 18 January 2011
[20] It is somewhat perplexing to note that the appointment of a Competent Person, although recommended by the UKLA, is not mandatory for a Main market listing, although it is for AIM.
[21] *International Mining*, May 2007, page 39

Brinkley"s other major interest was in DR Congo"s own uranium deposits, specifically in war-torn Katanga Province. In October 2006, Brinkley signed an agreement with the state CGEA (Atomic Energy Authority) whereby a new company would be formed, called SOCIMAR, over which Brinkley would have board control.

SOCIMAR would be entitled to access and test five areas for the presence of uranium, while Brinkley also pledged to certify "export materials with a view to implementing proper controls and to restrict the illicit export of radioactive material."[22]

This plan seemed sound and above board, lending an air of legitimacy to the unusual clause in the agreement by which Brinkley would also be granted priority rights to any uranium discovered from its explorations. (Unusual because uranium is a strategic mineral; indeed some of this fissile fuel included in the bombs dropped on Hiroshima and Nagasaki came from Zaire, today"s DR Congo).

However, despite this early promise, Brinkley sustained a pre-tax loss of nearly £1 million for the first half of 2007 and, by the end of the year, was still awaiting its prospecting rights from the Congolese government. The *Financial Times* reported on 18 September 2007 that Brinkley"s shares had "slumped to a new low yesterday in spite of insisting that mining agreements signed with the [DRC government] were legally binding. Reports at the weekend suggested the arrangements were under threat as part of a DRC anti-corruption drive".

Indeed they were; to such an extent in fact that, by September 2008, Brinkley had been forced out of DR Congo, as well as withdrawing from Chad. And just a year later (August 2009) the company announced it would dispose of its two remaining assets in South Africa and the Sudan – instead turning itself into "an investing company with its main asset being its cash balance"[23].[24]

So what had happened to bring Brinkley down?

From the outset, pointed questions might have been asked about the role of the company"s Executive Chairman, Gerald Holden, a financier who spent most of his career at Barclays Bank, where for seven years he was Global Head of Mining & Metals. Why was Holden able to take a position which, in principle at least, would seem to violate a key principle of transparent corporate governance, laid down in the 1992 Cadbury Report which addressed this very issue?[25]

It is clear that Brinkley was, to most intents and purposes, Mr Holden and – whether or not he was guilty of any corrupt dealings in promoting its DR Congo ventures (he has never been charged with doing so) – he was certainly less than circumspect in negotiating them and, at the very least, incompetent in defending them.

On 16 September 2007, two days before the company"s shares dropped to an all-time low, and while Holden was protesting the legality of his agreement with the DR Congo"s CGEA, Ben Laurance of the London *Sunday Times* broke a highly-disturbing story.

Laurance claimed to have established that "a convicted fraudster played a pivotal role in securing uranium mining rights in the Congo for the British minerals group Brinkley Mining." The alleged

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[22] *International Mining*, May 2007, page 39
[23] *Mining Journal*, 21 August 2009
[24] In December 2010 what was left of Brinkley was snapped up by Australia"s Eurogold, which valued the UK outfit at only just over £4 million [Reuters 8 September 2010]. By April 2011, Eurogold had apparently sold the Brinkley inheritance and gone out of business itself. A "Riches to Rags" tale indeed!
[25] The Cadbury Report was unequivocal in warning of the risks of failing to make a clear division of responsibilities at the top level of a UK business enterprise. In particular Cadbury argued that the position of Chairman of the Board should be separated from that of Chief Executive, or else that there be a strong independent element on the board [http://www.ecgi.org/codes/documents/cadbury.pdf]. On leaving Barclays Bank in 2005, and as well as taking the helm at Brinkley, Gerald Holden was also instrumental in putting together another highly controversial AIM-listed company, Asia Energy, later renamed GCM Resources plc, of which he is currently non-executive chairman. (This company will feature as another Case History in our forthcoming report). It should be noted that Anil Agarwal of Vedanta Resources plc has also occupied both positions, with Mr Agarwal defending his dual role as being "in the interests of the company"(!).

crook, a South African called Niko Shefer, had been "sentenced to 14 years in jail in the late1980s for his part in one of South Africa‟s biggest bank frauds. And a 2002 United Nations report into the plunder of the Congo‟s natural resources named him as one of 54 people who should be subjected to travel restrictions and penalties."

"It has now emerged that a Shefer company was instrumental in securing a deal for Brinkley to mine uranium in the Congo," declared Laurance, who went on to say that "since the deal was struck, Shefer was declared persona non grata by the government of the Democratic Republic of Congo (DRC) last month. The minister who approved the deal has been sacked and a civil servant involved in the agreement has been suspended."

But, said Laurance, "the company has yet to tell shareholders of the new developments," while "Shefer‟s role in Brinkley‟s DRC uranium project has never been disclosed to investors."

However, "papers seen by *The Sunday Times* show that Brinkley acknowledges that a key role in securing the deal was played by Sentinelle Investments. Shefer‟s wife‟s family trust has been a major shareholder in Sentinelle. Shefer‟s accountant is the company‟s sole director."

Moreover, said Laurance: "The other key Congolese player was Fortunat Lumu, head of the country‟s atomic energy commission. He was suspended from his job this year after being accused of agreeing uranium deals with Brinkley without the authorisation of DRC president Joseph Kabila. Science minister Bonane was sacked from the government in July – only days after Brinkley announced in London that a deal with the DRC had been signed".[26]

On 18 September 2007, Holden defended Brinkley in an interview he gave to Allan Seccombe of miningmx.com. Without naming any specific party, he claimed that: "People have been putting rumours into the market for some months now to damage us and get us out of the DRC". Holden agreed that Sentinelle Investments "had laid the foundations with the CGEA for about 90% of the transaction" although claiming this was "before Brinkley bought the deal."

However he then went on to say that Shefer – the convicted fraudster – was "extremely well connected in the DRC, making a valuable consultant (sic)" and went so far as to admit that Brinkley had put some reliance on Shefer, although claiming this was "sporadic and likely to become less as the company set up and established its own networks in the country." Moreover, said Holden: "We‟ll use whoever we need to at different times and if Nico can help then we will talk to him gain."[27]

A year later, and with his outfit clearly on the brink of collapse, this saga might have been forgotten. However, among the numerous "wikileaks" released in early 2011, was a cable dated 11 September 2007, sent back home by Roger A Meece, DR Congo‟s US Ambassador, which cast some further illumination on this decidedly murky affair.

Meece was concerned to examine allegations that a company called Malta Forest, long active in DR Congo, had been "trafficking" uranium illegally out of the country. He could not find compelling evidence that this was so. What Meece did confirm, however, was that Fortunat Lumu – the CGEA official named in Laurance‟s Sunday Times story – "planned to…push Malta Forest aside and form a personally profitable partnership with Brinkley."[28]

On 3 April 2009, the DR Congo government released its findings into a host of contracts, concluded under the previous regime, which raised major questions about their legitimacy and the complicity between former leaders and officials and overseas mining companies. The Congolese peoples had suffered the most brutal conflict in the recent history of Africa – nor is it yet at an end. In this regard, the role played by AIM-listed Brinkley Mining may merit only a footnote in future

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[26] "Congo purge puts Brinkley deal in doubt", Ben Laurance, *Sunday Times*, 20 September 2007.
[27] "Brinkley hits back in DRC uranium fracas", miningmx.com, 18 September 2007.
[28] See: "Wikileak reveals a uranium scandal" Mines and Communities, 11 January 2011: http://www.minesandcommunities.org/article.php?a=10634.

history – if that. However, in light of the manifest failure of UK regulatory authorities to maintain a thorough, ongoing check on the company"s activities – even when allegations of impropriety, verging on corruption, surfaced in the national press – the "Brinkley case" is far from being a mere quirk in a foreign country"s struggle to regain its independence. At the very least, Brinkley betrayed the financial interests of its shareholders, relieved as it was from a duty of transparency over its negotiations, and the lack of any official enquiry into its dubious manner of operating.

AFRICAN MINERALS LTD and LONDON MINING PLC in SIERRA LEONE

African Minerals Ltd

African Minerals Ltd is listed on the Alternative Investment Market (AIM) but is a "non-UK registered company and as such not all fields of data are available at this time" – to quote the formula used by Hemscott, a leading UK investors" services provider (see also Gem Diamonds case study in this report). In fact its registered office is in Bermuda.

What we do know is that the company is "in the gift" of Frank Timis, initially its Executive Chairman (yet another example of a breach of the guidelines for good corporate governance, set down in the Cadbury Report twenty years ago – see Brinkley case study).

Timis is a 46 year old Romanian-Australian financier, domiciled in London and known as "The Gusher" for an excessive vocal manner. When interviewed by the *Evening Standard* at a hotel in January 2010, Mr Timis was refused a vodka. "What do you mean, I can't have a f---ing vodka?" he asks. The waitress says he has got to eat. "Okay, we'll have a f---ing bag of chips then," says Timis."[29]

It is not only waitresses who may be uncomfortable with Mr Timis – and certainly not those who took a flutter on his Regal Petroleum outfit some years ago.

They put their money on what seemed a promising Greek oil discovery, hyped up by Timis between June 2003 and May 2005, before the find proved to be chimerical ("commercially unviable"). In 2009, Regal was fined £600,000 by AIM – the largest penalty it had yet imposed – when the Market found that Timis" company had "on 11 separate occasions … failed to take reasonable care to ensure its announcements were not misleading, false or deceptive, and did not omit material information."[30]

Just as he was lording it over Regal, Timis bought into the Sierra Leone Diamond Corporation, via his Bermuda-registered Timis Diamond Corporation Limited, from which he formed African Minerals Ltd and gained access to some Sierra Leonean diamond fields and the highly prospective Tonkolili iron ore lode.

In January 2008, Sierra Leone Diamond had been fined £75,000 for putting out "misleading and unrealistically optimistic information", following statements, made by the company in summer 2006, which claimed it had found "a significant number" of rare pink diamonds in Sierra Leone. But – and as the company admitted in December that year – the pink hue got "washed out" when put through an acid-cleaning process.[31]

What is doubly disconcerting about this incident is that, while Timis made some attempt to correct the official record, it took a year and a half before the LSE took any steps to censure the company,

[29] *Evening Standard*, 10 January 2010
[30] Curiously, in the light of Lord Adair Turner"s claim of October 2008 that the days of Financial Services Authority "light-touch regulation" were over, the following year Timis acquitted the FSA of being responsible for damning his Regal scam. He told the *Evening Standard* that the FSA had "made a full investigation. I spent eighteen hours with them, answering their questions, and I am in the clear." But Timis had no such charity for AIM, adding, "Then AIM looked at it and held a f---ing kangaroo court." [*Evening Standard*, 10 January 2010].
[31] *Financial Times*, 19 July 2010

and did so by way of only a "private censure", accompanied by a relatively modest £75,000 fine (around the price of a genuine 1 carat intense pink Argyle diamond). Worse – it appears that the public was not informed about this censure for another two and half years when the *Financial Times* divulged it in July last year.[32]

It is not sparklers, so much as the allure of iron, that is now spurring Timis on – African Minerals began testing the Tonkolili deposit in Sierra Leone in 2003. This might host a massive 10 billion tonnes of ore (though grading at a relatively low 58.1%). The company was finally granted a mining licence in July 2009 which currently covers an area of 227 square kilometres.

However, over the past nine months, some Sierra Leone local citizens claim to have been literally bulldozed by Timis‟ company, while others declare that they have been fired upon by "security" forces protecting his interests.

According to the country‟s Right to Food network: "Since 2003 African Minerals has…promised development, jobs and better infrastructure. Nevertheless, its operations have resulted in bloody confrontations.

"500 people live in Kemedugu [where African Minerals operates], but when we arrived there it seemed like a ghost town. Only a dozen inhabitants came out to meet us on the village square, and bullet holes from the last riot were still visible on a number of the houses.

"The protest is said to have been triggered by the firm's attempt to conduct surveys regarding the upcoming construction of a dam. One village inhabitant told us, „If they build the dam, we will lose water for our fields. We are afraid that we will not be able to grow enough rice.‟ According to the police a number of young men working for African Minerals attacked the firm's headquarters and set an excavator on fire. The police response was massive. They stormed the village and destroyed a number of houses. More than eighty people were arrested and there were numerous injuries, some of them serious. The majority of the villagers fled to the nearby forests. Those who have returned to the village fear further attacks. As yet African Minerals has refused to respond to the request by a member of the alliance for the Right to Food for a statement regarding the incidents.

"According to the villagers the firm has refused to engage in any dialogue with them. They have attempted to communicate with the firm on innumerable occasions and negotiate a compromise involving compensation for the land the firm is using – to no avail. The only result has been massive police violence… Even though African Minerals also talks about infrastructural improvements on its website, there is no evidence of these in Kemedugu. „We are afraid that our land will be ruined by African Minerals and we will not be provided with any compensation,‟ says [Kemedugu Chief] Musa Turay bitterly."[33]

London Mining plc

Running parallel with African Minerals‟ iron forays into Sierra Leone are those of another AIM-listed miner, London Minerals plc. In contrast to Timis dubious vehicle, London Mining is a company driven by an eminent board of non-executive directors, backed by a clutch of "respectable" investment funds (including F&C Asset Management, Schroder Investment Management, Fidelity Investment, Blackrock Inc, Union Bank of Switzerland, Investec and Barclays Wealth); none of which hold a pre-emptive stake in the company.[34]

Despite (or even because of?) what appears to be a more responsible, if not squeaky-clean, board, London Mining has not progressed half as far at its Marampa project as African Minerals has at

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[32] *Financial Times*, 19 July 2010
[33] "Merely empty promises?" 17 December 2010: http://www.madam-sl.org/?Projects:Right_to_Food. See also: "Massive iron ore project brings mining tensions back to Sierra Leone" by Paige McClanahan, *Christian Science Monitor*,12 December 2010; and "After diamonds, iron foments Sierra Leone tensions" by Simon Akam, Reuters, 8 December 2010.
[34] Hemscott Premium, accessed 12 April 2011.

Tonkolili. It has not achieved any revenue for the past two years and, in February 2011, reported a pre-tax loss of US$58 million for the fourth quarter of 2010.[35]

And, in November 2010, Sierra Leone's environmental protection agency temporarily suspended London Mining's on-site operations, due to its failure to comply with environmental regulations. “Yet by the end of the day the head of the agency recanted and the company announced work was going on as usual.”[36]

The company gained some extraordinary concessions from the Sierra Leone government, which allowed it an 80% reduction in income tax for ten years (a “tax holiday”), and an 80% reduction in other major revenue streams for no fewer than 26 years.

Its corporation tax was fixed at only 6% (in contrast to the 37.5% set under Sierra Leone‟s 2009 Mining Act); duty on mining materials at 1% (rather than the official rate of 5%); royalties were reduced to 3%, rather than the 4% mandated by state law.[37] (African Minerals also benefited from some concessions; its corporation tax rate was set at 26%.)

Sierra Leone is one of the world‟s poorest nations, yet endowed with some of its richest mineral deposits. For decades it has been emblematic of the so-called “resource curse” – not to mention the ravages of an horrendous recent war, centred around its mining fields. As the people begin to recover from these traumas, so a number of organisation have vigorously struggled to recapture the proceeds of mineral wealth in order to “rebuild” the nation‟s civil society.

At the February 2011 World Social Forum, held in Dakar, Senegal, Sierra Leone's Network Movement for Justice and Development (NMJD) along with the Association of Journalists on Mining and Extractives (AJME), hosted a symposium on „Reforms in Mining Regime - Challenges in Sierra Leone'.

The symposium announced that the West African country “since the early 1980s till date, has produced billions and billions of dollars‟ worth of precious minerals, but yet remains at the very bottom of the human development index and classified as a least developed nation.

“While structures such as the Presidential Task Force, the Strategic Policy Unit, the Anti Corruption Commission, the Income Tax Act of 2000, the Law Reform Commission etcetera have been put in place to enhance reforms that would ensure that the country benefits most from its already hugely depleted mineral wealth, it came out that the said structures are yet to display much seriousness in fulfilling their all-important mandates.”

Concerns were raised that “political will seems to be there but that undue priority is being given to attracting investors of all sorts, rather than striving to change the resource-curse syndrome, thereby meeting the expectations of the electorate and the suffering masses.”

According to panellists at the forum, while the 2009 Mines and Minerals Act “has the potential of changing the history of mining in the country”, nonetheless “the continued violation of some of its crucial provisions to so-called attract investors who often turn out to be economic criminals, is undermining the very act and at the same time treating the laws of the land with disregard.”

And in this respect, the two AIM-listed mining companies, African Minerals and London Mining, were singled out for indictment.

[35] Dow Jones Newswires, 24 February 2011
[36] See: “After diamonds, iron foments Sierra Leone tensions” by Simon Akam, Reuters, 8 December 2010.
[37] *Mining Journal*, 22 October 2010

LSEG Response to HMT Consultation: "A new approach to financial regulation: building a stronger system"

14 April 2011

Submitted to: financial.reform@hmtreasury.gsi.gov.uk

Introduction

The London Stock Exchange Group (LSEG) welcomes the opportunity to respond to this consultation; the UK regulatory structure and its operation are key elements to the stability and attractiveness of the UK's financial services sector and her capital markets.

The UK financial services sector is a key contributor to the real economy. It supports in excess of one million jobs in the UK[1] alone and in 2009, contributed in excess of 10 per cent of total tax revenues[2]. The London Stock Exchange (LSE) itself is an essential facilitator of non-bank finance to UK companies and the access to equity finance provided by its markets has been a major economic stabiliser for UK companies during the crisis. Through the LSE, £163 billion has been raised by UK businesses, both large and small, since September 2007.

The LSE is home to over 2,050 UK companies that have a combined value of over £2 trillion. It also plays a key role in attracting international companies to listing in the UK. Currently over 590 international companies from 70 countries with a combined market capitalisation of £2.028 trillion[3] are listed on the LSE's markets, underlining the international scale and global importance of London's financial markets.

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[1]" International Financial Markets in the UK – May 2010 (http://www.thecityuk.com/media/154873/ifm%20in%20the%20uk%2005%202010.pdf)

[2] "Total Tax Contribution – PricewaterhouseCoopers LLP second study of the UK Financial Services Sector for the City of London Corporation – December 2009 (http://217.154.230.218/NR/rdonlyres/F825E02D-B7CD-4AA8-8467-3B8A7999F9DF/0/TTCreport.pdf, paragraph 3.2).

[3] Source: London Stock Exchange, March 2011. These are companies that are either listed on the Main Market or admitted to AIM

Executive Summary – LSEG Key issues

1. The correct balance between financial stability and economic growth must be struck to preserve the attractiveness of the UK's markets.

    - The FCA should have a fourth operational objective to ensure the relative attractiveness of the UK's markets.
    - The UKLA should also have an operational objective to ensure the relative attractiveness of UK markets to reflect its essential role of attracting international business to the UK.
    - We support the FCA having the promotion of competition as an objective, but concurrent powers are inappropriate and risk undermining the operation of the UK's competition regime.

2. A clear rationale and justification for the proposed changes to the Recognised Bodies regime, and powers of direction over unregulated holding companies, must be provided, setting out the failings that the Government is seeking to address.

    - No rationale or justification is given for "technical improvements" to Part XVIII – where was the market failure in the RB regime?
    - The proposals take no account of the adverse impacts on the regulatory standards of markets that RBs provide and supervise.
    - A more prescriptive approach is likely to lead to a less expansive dialogue between regulators and regulated entities, resulting in less effective regulation.

3. It is essential to fully engage in the European process to ensure that the UK's voice is heard.

    - The legislative agenda is increasingly driven by Europe; the need for a strong and unified voice is critical.
    - The importance of effective coordination between the regulatory authorities, the Bank, and the Government to ensure that all parts of wholesale markets are fully and adequately represented – especially CCPs and settlement systems.

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PART A: Key issues

In this section, we highlight our key points and issues, as set out in more detail in Part B. They are:

1. The relative attractiveness of the UK as a destination for international business and capital must be a key priority for the new regulators and for the Government

- **London is the leading financial centre in the world**[4] – In 2009, London accounted for 16 per cent of global further issues by money raised and around a fifth of global foreign equity trading[5]. It accounts for 70 per cent of the global secondary bond market, 75 per cent of global Eurobond trading and 34 per cent of foreign exchange trading[6] and there are currently 590 international companies from 70 countries with a combined market capitalisation of £2.028 trillion[7] listed on our markets, underlining the international scale and importance of London's financial markets. Over $1.6 trillion of equities are managed out of London, with $888 billion invested in international equity assets, more than any other major financial centre (including New York at $804 billion and Paris at $202 billion)[8].

- **The financial services sector provides real benefits to the UK economy** – it supports nearly one million jobs in the UK and in 2009 it contributed in excess of 10 per cent of total tax revenues[9]. We estimate that the capital raising activities of firms listed or admitted to our markets help to support in excess of 8 million jobs across the UK[10]. The sector is also essential for the support of SMEs, who themselves a key source of growth – our stock market for smaller companies (AIM) has raised £73 billion for high growth companies since its 1995 launch.

- **It is imperative that UK policy makers and regulators have regard to the relative attractiveness of the UK markets when taking regulatory decisions** – the failure to take account of regulatory developments on a global scale, particularly in the context of a dynamic and rapidly changing industry environment, runs the real risk that the UK's markets lose their appeal for international business, delivering a serious blow to the UK's economic health. We believe that the FCA, in particular, should have regard to the ongoing importance of ensuring the relative attractiveness of the UK's markets.

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[4] The Global Financial Centres Index 8, September 2010, Z/Yen Group
[5] International Financial Markets in the UK – May 2010 (http://www.thecityuk.com/media/154873/ifm%20in%20the%20uk%2005%202010.pdf)
[6] Data from the CityUK and IRSG, 2009
[7] Source: London Stock Exchange, March 2011. These are companies that are either listed on the Main Market or admitted to AIM
[8] Ipreo, June 2010
[9] "Total Tax Contribution – PricewaterhouseCoopers LLP second study of the UK Financial Services Sector for the City of London Corporation – December 2009 (http://217.154.230.218/NR/rdonlyres/F825E02D-B7CD-4AA8-8467-3B8A7999F9DF/0/TTCreport.pdf, paragraph 3.2).
[10] Thomson Datastream – based on employment numbers for UK companies listed or admitted to our markets. This does not account for those companies who rely on listed entities for their business. It should be noted that there is no empirical link between capital raising on our markets and job creation. However, capital raising is used to fund companies' growth strategies and operations

- **There is a real need for a commercially-orientated UKLA** – to ensure the attractiveness of London as a capital raising centre is preserved and in the interests of UK companies, it is vital to have a quick, efficient and relevant listing and capital raising process in the UK. This requires a commercially-oriented UKLA, which is up to speed on the latest market practices and developments and integrated into the wider regulation of wholesale markets.

- **It is not appropriate for the FCA to possess concurrent powers with regard to competition –** the financial services sector is highly competitive and dynamic, very different from the structures that exist in the utilities sector for which concurrency was designed. We also query whether the FCA, as a prudential and conduct regulator, would possess the expertise required to undertake an economic review of the industry. This is an activity better suited to the OFT and the Competition Commission.

2. Any changes to Part XVIII must be fully justified setting out and targeting the failings that the Government is seeking to address

- **There is no evidence of RB failure and no case for change is made** – During the financial crisis, infrastructure providers continued to operate effectively and in an orderly manner, despite issues in other areas of the financial sector. As such, infrastructure providers were a key stabilising force. This is evidenced by the £163 billion raised through primary and secondary issuances on LSE's markets since September 2007.

- **The proposals to make "technical improvements" to Part XVIII fail to explain how they would enhance the stability, efficiency or strength of the UK regulatory system –** the stated objective of the FCA is to enhance confidence in the UK financial system. The proposed changes in fact risk undermining the quality and effectiveness of the relationship between regulators and regulated bodies.

3. Effective interaction with Europe on the legislative agenda is essential to ensure the UK's view is taken into account in future legislative initiatives

- **Many initiatives currently underway in Europe will have a deep and lasting impact on the economic prospects of the UK –** In order to achieve an outcome that is beneficial to the UK, it is essential that the regulatory authorities and the Treasury engage effectively and fully in Europe.

- **Effective engagement also requires that the regulatory authorities speak with knowledge and authority in Europe –** despite being the centre for wholesale finance in Europe, the UK will possess only limited voting power at the new ESAs. It is therefore essential that our regulatory authorities have the greatest possible credibility to enable them to represent effectively the UK's interests.

- **Coordination and cooperation between the regulatory authorities will therefore be essential –** so as to ensure that all areas of the industry will be fully represented, and the UK presents a coordinated and common position. This will be especially important for the representation of bodies that fall outside of the PRA or the FCA, including CCPs and settlement systems.

4. The power of direction over unregulated holding companies risks undermining the relative attractiveness of the UK's markets

- **The measures could lead to significant levels of uncertainty for firms –** and may have the effect of deterring foreign businesses from locating in the UK, with the negative impacts that this would have on the UK economy.

- **Such a measure could undermine the nature of the relationship that firms enjoy with their regulators –** the current regime allows a great amount of flexibility in the way that authorities deal with the firms that they regulate, and gives rise to cooperative dealings. Such a measure would risk creating a more legalistic dialogue between firms and authorities, with a negative impact on regulation.

PART B: Responses to Consultation Paper Questions

This section contains LSEG's more detailed responses to the specific questions posed in the Consultation Document.

1. The Bank of England and Financial Policy Committee (FPC)

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

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

1.1 Whilst we support the FPC's objective of maintaining financial stability, **the body should have regard to the relative attractiveness of UK institutions, ensuring that they are able to compete effectively with their international peers.**

1.2 It is important that financial stability is properly defined to ensure that the success of the FPC can be accurately measured. This will also allow the remit and the role of the FPC to be more accurately defined.

1.3 Financial stability is not a free good[11]. Achieving full stability will, as a necessity, require trade-offs – whether between stability and economic growth, stability and competitiveness or stability and innovation. **It is essential that the correct balance is struck to ensure that innovation and economic growth are not squeezed out by excessive regulation, and that the UK remains an attractive destination for international business.**

1.4 The design and use of macro-prudential tools should be done in such a way so as to align with international developments in prudential policy and accounting standards. This is essential to ensure that the UK is not placed at a competitive disadvantage.

1.5 Further, the UK's financial services sector is one of the most international in the world[12] – if regard is given only to economic conditions in the UK, the use of these tools is likely to prove ineffective, and may undermine the attractiveness of the UK's markets.

[11] As noted in the Treasury Select Committee's report – "Financial Regulation: a preliminary consideration of the Government's proposals, Volume 1", 3rd February 2011

[12] Please see section 6 of our response

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

1.6 In paragraphs 1.2 and 1.3 above, we note the importance of accurately defining financial stability, and therefore of exactly defining the remit and scope of the FPC. Achieving a trade off between financial stability and economic growth is ordinarily the role of fiscal and public policy.

1.7 To that end, we would welcome greater participation of the Treasury in the operations of the FPC. Whilst we recognise the importance of the independence of the FPC, macro-prudential regulation is likely to have a significant socio-economic impact, particularly in the short-term. As a result, it is essential that adequate linkages are created between the FPC and the Treasury in order to ensure an adequate balance is struck between financial stability and economic growth.

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

1.8 We welcome the proposal that recognised clearing houses and settlement systems should be directly regulated by the Bank of England. These institutions are systemically important, and are likely to become more so, as more financial instruments, such as OTC derivatives, start to be cleared through them.

1.9 However, it is essential that close links are retained with the Markets Division of the FCA. CCPs and settlement systems are inextricably linked with trade execution, so maintain close links with recognised investment exchanges and MTFs.

1.10 Further, the activities of CCPs and settlement systems will be subject to regulation by ESMA at a European level, and the FCA will be the UK's representative there. It is essential that, given the size of the UK's wholesale markets, and their importance, that the FCA speaks with authority at this body. Effective lines of communication and coordination must exist between the Bank and the FCA therefore, independent of those that will operate between the PRA and the FCA.

2. Prudential Regulation Authority (PRA)

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

2.1 Whilst we support the PRA's strategic objective of promoting financial stability through micro-prudential regulation, **we believe the body should act in such a way to ensure that the relative attractiveness of UK firms against their international peers is maintained.**

2.2 As we stated in paragraphs 1.2 and 1.3, **it is essential that an appropriate balance is struck between attractiveness and economic growth on the one hand, and financial stability on the other.**

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?

2.3 As currently drafted, there are a significant number of firms who could be deemed systemically risky.

2.4 The London Stock Exchange Group operates two BIPRU 730k firms with permission to deal on their own accounts: EuroMTS Ltd and Turquoise Services Ltd. Both are authorised investment firms that operate multi-lateral trading facilities (MTFs).

2.5 **We believe that it would be inappropriate for these firms to be regulated on a prudential basis by the PRA.** MTFs do not leverage their balance sheets or put at risk funds belonging to their clients in the same way that a bank does. Instead, they provide a neutral infrastructure to enable their clients to execute and complete transactions in securities. During the crisis, infrastructure providers continued to operate their markets effectively and in an orderly manner, remaining open whilst other parts of the financial sector seized up. **As such, infrastructure providers were a key stabilising force.** The crisis was a result of a failure of prudential oversight, not a failure of market infrastructure.

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)?

2.6 We generally welcome the PRA being a more risk based, judgement-led regulator. However, it is important that the criteria by which it reaches judgements about firms are transparent, predictable and applied consistently.

2.7 It is important that the rule making functions of the PRA are subject to the same safeguards that currently exist for the FSA, and which will be applied to the FCA. These include the necessity to consult, both publicly, but also to a Statutory Panel, in the same way that the FCA will be required to do. Detailed market failure analysis and a robust cost benefit analysis should also be mandatory. However, we do not believe that the PRA should be formally accountable to a Practitioner Panel, and should remain accountable only to the Court of Directors of the Bank, and to Parliament through the Treasury Select Committee.

2.8 In addition, the quality of staff and the information flowing to those staff will be crucial. Focusing on recruitment and retention of suitably experienced staff with expert knowledge will, therefore, be essential.

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

2.9 Generally we welcome the governance structure of the PRA, in particular cross-membership with the FCA, the FPC and the MPC.

2.10 However, we reiterate the point we made in our response to the initial consultation last year, as to the importance of the non-executive directors of the board being fully involved in all major decisions taken. Paragraph 3.39 of the consultation suggests a contrary position, stating that key decisions involving major firms would be made by an executive committee of the board. We see this as undermining the role of the NED which should be corrected. We also suggest that such an approach may affect the quality of individuals that can be attracted to become NEDs of the PRA; why would someone want to be a NED if they may not be party to relevant decision-making whilst being responsible as directors for decisions made?

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

2.11 We welcome the measures outlined for the accountability of the PRA, in particular that the PRA will remain accountable to Parliament through the Treasury Select Committee, and will be subject to full audit by the National Audit Office and accountable to the Public Accounts Committee.

2.12 However, we note in paragraph 3.62 of the Consultation Document that external scrutiny of complaints will be carried out by an independent person appointed by the Bank. To ensure that this is perceived to be fair, the appointment process must be sufficiently independent and transparent.

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

2.13 Please see paragraph 2.7 – in particular our view that the PRA should engage with a Practitioner Panel in the same way that the FCA will be required to do.

3. Financial Conduct Authority (FCA)

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

3.1 Given the importance of the financial services sector to the UK economy, achievement of the FCA's primary objective of protecting and enhancing confidence should be measured against the impact of its decisions on the relative attractiveness of the UK's financial markets.

3.2 We believe that the FCA should have a fourth operational objective **to ensure the relative attractiveness of the UK's markets.**

3.3 This is essential for the economic health of the UK. The financial services industry is one of the largest employers in the country, representing approximately 9 per cent of the UK's GVA, and almost one million jobs[13]. Further, since the beginning of the financial crisis, over £163 billion has been raised by UK companies on the London Stock Exchange, helping to fund their growth strategies, and support jobs.

3.4 We support the objective of the FCA to promote competition. However, we believe that this can only be accomplished through the adequate facilitation of choice, innovation and international competitiveness. It is important that the regulators pay due regard to these in order to achieve their objective of competition, and the "positive outcomes" that should arise.

3.5 Further, we suggest that there are risks and disadvantages to the FCA to possessing concurrent powers. Please see our answer to question 15 for more detail.

3.6 We welcome the fact that the FCA will play an important role in removing regulatory barriers in order to achieve greater efficiency and choice[14].

3.7 Finally, we agree that it is vital that the FCA should take a differentiated approach to the areas under its remit. In particular, it is essential that the relative differences between the regulation of wholesale and retail markets are recognised. For example, the UKLA deals with neither conduct nor prudential issues – and should have regard to the attractiveness of the UK's markets (we expand on this point in our answer to question 16).

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[13] Source: ONS Regional Gross Value Added, and the ONS Economic and Labour Market Review
[14] Paragraph 4.15 of the Consultation Document

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

3.8 We welcome the retention of the Practitioner and Consumer panels, and that the Smaller Business Practitioner panel will be placed on a statutory footing and the new proposals for a Market Panel. We assume that LLAC will remain an independent and separate body.

3.9 We also welcome the increased intervention powers of the Treasury, where it is deemed that there has been a regulatory failure.

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

3.10 Whilst we support the principle of product intervention powers, any exercise of such powers must be subject to transparent criteria in order to give clarity and certainty to the process of product design and implementation.

3.11 It is also essential that the exercise of this power is appropriately balanced to ensure that innovation and competitiveness is not unduly hampered.

3.12 It will be essential for stakeholders to be able to comment fully on the specific detail during pre-legislative scrutiny to ensure that there is certainty over the level of involvement, the point at which intervention may occur, and to consider what the potential impacts may be. It will also be necessary for the government to consider the extent to which even limited product intervention powers could mean that the FCA is "approving" products and the unintended consequences of such an approach.

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.**

3.13 We support the use of transparency as a regulatory tool; however, it needs to be appropriately balanced with the need to maintain market confidence and stability.

3.14 The proposals, as currently worded, would not achieve full transparency. Instead, they would create a hybrid system whereby there was transparency regarding action to be taken, but not the likely outcome, or details of the investigation. It is likely that this would create uncertainty, which would be detrimental to both consumers and firms.

3.15 It is essential that there is certainty as to the outcome of the investigation, before an announcement is made regarding enforcement action. This is in the interests of consumers, firms, and the orderly functioning of markets.

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?

3.16 Regarding the proposed competition powers to the FCA, we believe that competition drives innovation, best practice, and helps to lower prices. As such, we fully support competition in markets.

3.17 If the intention is for the FCA to have a general duty to ensure competition in the markets and the conduct it regulates, we support this. However, if this is intended to give FCA powers similar to sector regulators such as OFGEN, OFWAT and OFGAS, we suggest that this is not appropriate for the following reasons:

- **The financial services industry is very different from monopolistic utility sectors –** these sectors were traditionally dominated by large, monopolistic entities that had recently been privatised. There was a clear need to encourage competition as a way of diminishing those dominant positions, and as such their sector regulators were handed concurrent powers. **Financial services markets fall into a separate category, and the industry is already highly competitive.** The FSA currently regulates over 18,000 authorised firms, including 318 authorised banks[15]. By contrast, OFWAT, for example, regulates just 21 regional monopoly water companies in England and Wales[16]. It was noted by the House of Lords Select Committee on Regulators that *"…[Financial services markets] are highly competitive [and] the regulator did not face a comparable task of facilitating the transition of a monopoly to a competitive market structure."*[17] This point was endorsed by the FSA in the same report.

- **It is clear that many commentators and users also find the sector regulators system expensive, inefficient and uncertain** and it would require detailed description of the process and scope to distinguish itself and be effective.

- **The FCA is not an economic regulator –** and we question whether it is reasonable to expect the FCA to build up the necessary competencies to keep the industry under review effectively, whilst also being an effective prudential and conduct regulator. This point was noted in the recent consultation by the Department for Business, Innovation and Skills, who stated that sector regulators in other industries may lack the expertise and resources to prosecute antitrust cases[18].

- **Other options available to regulators will provide a swifter, more rapid and effective outcome –** the rule making powers that the regulators possess can bring about a beneficial outcome without the requirement to launch an anti-trust case. This fact may be behind the reason why so few cases have been prosecuted by sector regulators so

[15] The FSA web site, and "Financial Markets in the UK – November 2010
[16] http://www.ofwat.gov.uk/regulating/
[17] House of Lords Select Committee on Regulators, UK Regulators Volume I Report, 13 November 2007, paragraph 7.8
[18] "A competition regime for growth: a consultation on options for reform" March 2011, paragraph 7.10

far – only 2, compared to 25 cases and 9 MIR's made by the OFT across the economy as a whole[19].

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.**

Proposals for RIEs and Part XVIII of FSMA

3.18 We welcome the fact that Part XVIII of FSMA will be retained, recognising the substantial differences between recognised bodies which provide critical market infrastructure, and authorised firms carrying out investment activities either on their own behalf or on behalf of their clients.

3.19 However, we are given to understand that HMT are considering making a *"small number of technical improvements to Part XVIII".* These changes would include:

- Simplifying the procedures for issuing directions and allowing the FCA to impose penalties on an RIE; and
- Extending information gathering powers.

3.20 The rationale and justification for these changes have not been made clear in the Consultation Document. It is essential that stakeholders are able to comment fully on any detailed proposals during pre-legislative scrutiny.

3.21 It is not clear:

- **How the proposed "improvements" would enhance the stability, efficiency, or strength of the UK regulatory system** – a stated objective of the FCA is to enhance confidence in the UK financial system. It is unclear how these changes would meet this aim. The financial crisis came about because of a failure in the prudential regulation of authorised firms. There were no failings of the regime governed by Part XVIII, and no failure of market infrastructure occurred.
- **Does not set out the issues which HMT is seeking to address in relation to any changes –** there is no evidence of RB failure and no case for change is made. During the financial crisis, 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. This is evidenced by the £163 billion raised through primary and secondary issuances on LSE's markets since September 2007.

[19] A competition regime for growth: a consultation on options for reform" March 2011, paragraph 7.7

Proposals in relation to listing and primary market regulation

Bringing the objectives and regulatory principles of Part VI into the general framework of the FCA

3.22 We welcome the decision that the UKLA will remain within the FCA. This will help to ensure that the Markets Division within the FCA continues to speak with a strong and coherent voice.

3.23 We stated earlier in this response[20] that the FCA should have a fourth operational objective to **ensure the relative attractiveness of the UK's markets. This is of significant importance for entities such as the UKLA.**

3.24 The UKLA is a primary market regulator, and therefore its regulatory focus and priorities are, and should remain, different from that of the rest of the FCA. Primary market regulation is based upon the transparency of information and the integrity of markets, in order that investors can make decisions based on full and accurate information within an adequate timeframe. This regulation is closely linked to the detection and prevention of market abuse, but has less linkage to supervisory, prudential, or conduct regulation, which will be the prime focus of the FCA.

3.25 An effective primary market is critical to the ability of companies to raise capital for growth and development. This in turn supports a vibrant secondary trading market and delivers significant benefits to the real economy. **It is therefore vital to the UK economy that the UK's primary markets regulator provides a primary markets regime which continues to deliver efficient access to capital by remaining attractive to issuers and investors.**

3.26 **Attracting international businesses to the UK is of critical importance to the economy.** Large listed multi-national companies, whose primary operations are located overseas, have chosen to locate their headquarters in the UK because of its perceived "open for business" approach. This brings significant benefits to the UK economy in terms of jobs, skills and tax revenue to HMT. It is essential that the UK continues to remain an attractive place for businesses to locate.

3.27 In order to ensure that the UK remains an attractive international listing venue, the UKLA needs to offer consistency, efficiency and certainty. This can be achieved by:

- Offering practitioner certainty, including advertised service levels and turnaround times.
- The maintenance of a proportionate and balanced regulatory regime that seeks to balance investor protection with providing companies with access to capital.
- High quality and consistent responses to draft prospectuses provided within agreed timelines.
- Consistent and continued interaction with the financial community to ensure that market participants are fully involved in the regulatory process.
- Ongoing participation in ESMA and timely mitigation of any regulatory risks arising.

[20] Paragraph 3.2

3.28 On the basis that the FCA was given a fourth operational objective to have regard to the relative attractiveness of the UK's markets, then we would welcome merging the objectives of the listing authority under Part VI into the general framework of the FCA. However, were this not to be the case, then the objectives of the listing regime under Part VI should be retained.

Allowing the UKLA to require a listed issuer to have a skilled person prepare a report…

3.29 Regarding paragraph 4.112, bullet 4 of the Consultation Document, we view this as a significant and unjustified extension in the powers of the regulatory body. It is unclear what market failure this has been designed to address, and does not appear to have been properly analysed from a cost benefit perspective.

3.30 The use of section 166 powers on issuers is inappropriate by ordinary company law. Power already exists under the Companies Act 2006 for BIS to appoint inspectors. Listed issuers, who are not authorised investment firms, do not deal with consumers for whom special protections are required or to whom special duties are owed.

3.31 On that basis, the use of this power would be disproportionate, and would especially have an impact on small and medium sized enterprises. Such measures could represent a significant cost to such issuers, deterring enterprises from seeking a listing in London, and therefore reducing the liquidity of markets, with a consequent rise in the cost of capital.

Giving the UKLA powers to make rules, and impose sanctions, on primary information providers (PIPs)…

3.32 The Consultation Document fails to provide a clear description of the proposed powers of sanction or the circumstances which might require their use.

3.33 Since 2002, the PIP regime has operated in an effective and efficient manner, with no significant issues related to the distribution of information. To our knowledge, there has been no market failure which requires remedy.

3.34 As we have stated previously, a clear justification must be provided for the proposed change, and stakeholders must be able to comment fully on the detailed proposals.

4. Regulatory processes and coordination

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

4.1 Effective coordination between the PRA and the FCA will be of the upmost importance, but so to will be coordination between the Bank of England Group and the FCA. This will be essential for the effective regulation of CCPs and Settlement Systems at a European level.

4.2 It is important that a culture of coordination and cooperation is established between the PRA, the FCA, and the Bank of England Group in general. Though we support the statutory duty to coordinate, this culture will be better ingrained if subscribed to at the highest level. To this end, we fully support cross-membership of the boards.

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?

4.3 We believe that the FCA should be of equal prominence and importance to the PRA, and do not believe that a power of veto is appropriate. **This is especially important with regards to the UK's ability to influence policy development in Europe – the FCA must not be seen as a second-tier regulator.**

4.4 Further, as stated earlier in this response[21], what is meant by "financial stability" must be clarified. We note that the PRA will only have a power of veto over the FCA where financial stability is at risk, or where the action of the FCA would result in the disorderly unwinding of a firm. For this to be effective, it is important to know what could trigger a risk to financial stability, and therefore at what point the PRA would intervene.

4.5 With that in mind, we cautiously welcome the fact that the power of veto will be limited, and subject to transparency and accountability obligations[22].

[21] Paragraph 1.2
[22] Paragraph 5.25 of the Consultation Document

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

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

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

4.6 For all of the processes involved in the authorisation of firms, varying or removing their permissions, and the approved persons regime, we believe that it would be far more efficient for one regulatory authority to administer and manage them, whilst seeking input from the other authority. This would allow for a more streamlined approach that will be less burdensome for the firms involved. As the authority that will regulate all firms, this should naturally sit with the FCA.

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

4.7 We express no views on this question.

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

4.8 We express no views on this question.

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

4.9 We express no views on this question.

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?**

4.10 Our answer to this question focuses on the second bullet, i.e. the proposals to introduce a new power of direction over unregulated parent entities in certain circumstances.

4.11 In our view, we would expect regulators to use the process of authorisation of the regulated entity to access information from the unregulated holding company, making it a condition of initial and continued authorisation that such access and information was provided; we do not see why any further powers are necessary.

4.12 It is unclear what the rationale and justification for this change is, and what failings it has been designed to address. Further, it is currently unclear precisely what is being proposed, and under what circumstances such a power would be exercised. It is essential that interested parties are given the

opportunity to fully consider, and respond to, any detailed proposals, preferably before pre-legislative scrutiny.

4.13 The UK is currently home to 318 authorised banks, 241 of which are incorporated overseas or owned by a foreign entity[23]. This does not account for the significant number of authorised investment firms who are foreign owned. It is likely that such a measure would lead to significant levels of uncertainty and complexity, and further detract from the attractiveness of the UK's markets, and may have the effect of deterring foreign businesses from locating in the UK, with the negative impacts that this would have on the UK economy.

4.14 Finally, such measures could undermine the nature of the relationship that firms enjoy with their supervisors/regulators. The current regime allows a great amount of flexibility in the way that authorities deal with the firms that they regulate, and give rise cooperative dealings. A more prescriptive approach is likely to lead to a less expansive dialogue between regulators and regulated entities, resulting in less effective regulation.

Question 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?

4.15 We express no views on this question.

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

4.16 We await sight of the proposed text and powers and would have in mind the impact of such powers on the operation of default rules under part VII of Companies Act 1967.

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

4.17 We welcome the proposal that a non-statutory arrangement will be put in place for the collection of fees through one organisation (and assume that this will be the FCA).

4.18 **However, the process through which fees are set and levied must be transparent and fees themselves must not distort competition between entities conducting similar or the same activities.** As such, fees must be set in a transparent way and be fair, proportionate and balanced and the process should be subject to oversight, potentially by the NAO. **Further, the process by which fees are calculated must be identical for both the PRA and the FCA, and consistent with the process currently used by the FSA**.

4.19 **Finally, the way that rebates are redistributed to the industry should be equitable and consistent.** Currently, rebates of fees are distributed only to authorised firms[24], and not to those firms regulated under Part XVIII of FSMA (i.e. the Recognised Bodies). Given that Recognised Bodies are also required

[23] Source: "Financial Markets in the UK – November 2010" The CityUK
[24] 16(2), Part III, Schedule I, FSMA 2000

to pay fees to the FSA, it seems inequitable that they should not participate in any rebates.

5. Compensation, dispute resolution and financial education

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

5.1 We express no views on this question.

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

5.2 We express no views on this question.

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

5.3 We express no views on this question.

6. European and international issues

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

6.1 We welcome the recognition in chapter 7 of the Consultation Document of the importance of developments in Europe and internationally, and the measures proposed to ensure that the UK wields influence in European and international fora. Policy and legislative developments in Europe are going to have an increasingly large impact on the UK in the coming years.

6.2 **The financial services sector provides real benefits to the UK economy –** it supports upwards of one million jobs, and helps to fund the growth aspirations of companies, both large and small. We estimate that the capital raising activities of firms listed or admitted to our markets help to support in excess of 8 million jobs in the UK alone, and many more worldwide[25]. The sector is also essential for the support of SMEs – our stock market for smaller companies (AIM) has raised £73 billion for high growth companies since its launch in 1995.

6.3 **The UK's financial services sector is the most international in the world –** there are currently 590 international companies from 70 countries listed in London, with a combined market capitalisation of £2.028 trillion. 18 percent of cross-border bank lending, 37 per cent of foreign exchange trading, 21 per cent of marine insurance business, 16 per cent of global further issues capital raising, a fifth of global equity trading, 75 per cent of global Eurobond trading and approximately 9 per cent of IPOs are executed out of London[26].

6.4 **The European legislative agenda is becoming increasingly heavy and complex –** as discussed in the consultation, there are several initiatives happening now that will have a deep and lasting impact on the UK, including MiFID II, EMIR, corporate governance and CRD IV. It is essential that the regulatory authorities are able to devote sufficient time and resource to ensuring that the UK's voice is heard.

6.5 **Despite being the centre for wholesale finance in Europe, the UK will have only limited voting power in Europe –** it is essential, therefore, that the regulatory authorities speak with full authority and knowledge. Effective coordination between all the regulatory authorities, including the area of the Bank of England responsible for CCPs and settlement systems, will be critical.

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[25] Thomson Datastream – based on employment numbers for UK companies listed or admitted to our markets. This does not account for those companies who rely on listed entities for their business. It should be noted that there is no empirical link between capital raising on our markets and job creation. However, capital raising is used to fund companies' growth strategies and operations

[26] "Financial Markets in the UK – November 2011" The CityUK

GM financial management

New Approach to financial regulation

This response is submitted by

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Due to time constraints this submission is structured as a number of connected essays.

I apologise in advance for some unavoidable repetition.

I think that the central core of my comments is that the Regulator is acting more a Arch-Bishop in the religion of Regulation, than dealing with real problems.

It is more inclined to declare everyone a sinner than build a viable, cost effective industry on existing foundations.

Consumer outcomes are more a cloak for the FSAs own internal machinations that a genuine objective.

There is two much blether, and too few facts.

And the New Approach appears to address these problems with yet more blether rather than concrete assessments and targets.

In other words its really "More of the Same".

The title "Building a Stronger System" does not inspire hope.

A more effective system; a more Intelligent System; a more responsive system. These titles would have suggested that some lessons had been learnt.

Stronger generally does not automatically mean better. A stronger smell may not be to everyone's amusement. Stronger may mean less flexible - concrete is far stronger then a human, yet often has less success at surviving disasters.

The very fact that the concept stronger is used demonstrates a level of misunderstanding of the financial crisis, just as King Cnut misunderstood the interaction of his level of charisma and the laws of gravity.

Credibility and Direction

I have no confidence that this, or any other submission, will have any effect on the structure of the regulatory industry, because there is no evidence over the last 10 years of any level of genuine dialogue or discussion.

For this reason I believe that the regulatory strategy now in place, and that will be continued, has lost both credibility and direction. Regulation should be looked at as a necessary evil.

It is not constructive. It is not creative. It is rarely cost effective. But it is necessary to limit excess and to provide some guidance.

Generally regulators operate in industries that are near monopolies, energy, communications, transport were extremely large levels of capital are necessary to survive in a world market.

By any question banks would fall under this categorization. But the general perception of the regulator is that is took very little notice of what the banks were doing, leading to a catastrophic melt down.

When regulation started in the late 1980s there were well over a hundred insurance companies in a very competitive market, and with a wide range of products. Not all the products were good, but at least there was choice. Under regulation the number of insurance institutions has collapsed catastrophically to a level now were there is remarkably little choice.

When regulation started there was a large number of people advising/selling financial commodities. That population has now diminished, and is likely to contract further shortly.

So what precisely is the purpose of regulation? To ensure that liberties are not taken in a market were competition is limited, as with banks, or to reduce the level of competition in order to justify the existence of regulation, as with providers and advisers?

It is generally held that the most cost effective means of market regulation is competition. It's not perfect, but then nothing is. But it tends to be cost effective and innovative. Neither of those descriptions could be applied to the current regulator.

So what is the purpose of a regulator?

There is nothing in the discussion document that defines the function or the aim, other than in terms that can best be termed woolly.

Rather we are reading about the deification of regulation. It has now become the de facto modern religion, and it is not to be questioned. There are lots of wonderfully emotive phrases used.

Actually the basic requirement for a regulator is to ensure that people are provided with sufficient clear information that they can make a reasoned decision, and that this is undertaken in the most cost effective manner possible. The consumer should be the focus of the process not the regulator.

There is nothing in A New Approach that persuades this applies. It's really same again, this time with even more mysticism.

Are We Gods

In a sense the current debate on the effectiveness of regulation can be compared to the debate "Is there a God".

There are a thousand definitions of who God is; there is no factual proof there is a God; there is no factual proof there is not a God; there is no definition of how God functions; there is no definition of how God expects human beings to function. But there are opinions, without number. And the firmer that a person holds those opinions the less tolerant they are of an opposing view.

For financial services there are, again, opinions without number regarding what is right and what is wrong. But there is no proof.

A simplistic hypothetical example. An adviser sees a client who has a family and good level of life cover, but no pension provision.

In scenario 1 the adviser decides that there is more money to be made out of selling additional life cover, and does so.

In scenario 2 the adviser considers that the level of life cover is adequate and recommends that the client puts money aside for his eventual retirement.

So Adviser 2 has made the more ethical and professional recommendation.

12 months later the client is killed in a car accident.

Which of the two scenarios provide the family with the best outcome?

Under current rules the FSA would probably ban the adviser in scenario A and praise the Adviser in scenario B.

The family's reaction, and they are the consumer's of the advice, would be the reverse.

We come down to the problem that there are many opinions, but far too few facts.

And we come down to the fact that most of the operational opinions in the retail section of the adviser industry are those of the FSA, whose staff is amazingly bereft of any practical experience in dealing with clients.

Asset Allocation Tools

[This is taken from an article I wrote in January 2011 covering the consequences of non-specific guidance. I believe new Approach to be in the same category - it is far too general. Professional Civil Servants, which is what the FSA staff are in practice, will look at the language used with delight, since it gives them carte blanche to do virtually anything. It is a problem that has to be addressed, either by more direct legislation or by some other set of checks and balances. If there is anything less then this whole scenario will be repeated inside 10 years.]

There is no indication from the FSA why or how these asset allocation tools could cause a problem. We are obviously expected to guess.

There is no indication from the FSA which 9 of the 11 risk profiling tools were suspect or even why they were suspect. What were the circumstances in which they could lead to poor conclusions? We are obviously expected to guess.

What rules were they using for equating appetite for risk to portfolio construction? Based on the fact that there is no known research that causally links the two it is certainly necessary for the FSA to state why those remarks were made, and for two reasons.

One, it provides feedback to the investment practitioners so they can improve their processes, and two, the FSA's process may be badly flawed and it may be they need to adjust their approach.

The FSA stated that firms would need to look at the underlying asset's in a fund and the product structures. How far does this go before an adviser has sufficient involvement in the analysis of the funds that it would almost be easier to be a fund manager themselves. Advisers do not generally have the expertise to undertake these analyses, nor is it likely to be possible with at least 34,000 funds available. The FSA requirement as outlined is bizarre beyond belief. The research required before making any recommendation would be such than no firm would ever really be in a position to make any recommendation, especially as the investment and structures of collectives change constantly.

The major problem here is that the FSA has lain down a set of guidelines without any detail in the guidelines, no explanation or rationale, or any way in which their own processes can be reviewed. It is not unknown for Government bodies to get things wrong.

They state they have taken tough action - but again no clarification.

The whole process can only be described as bizarre. It is as though someone has said "You should be ready for the weather" and stopped there. What type of weather? Hot, cold, wet, dry? What preparations?

'Oh, yes. We found that some preparations were inadequate'. What, how, why? Would you treat that person with any respect, or merely as an idiot?

So much of the rule by the FSA is rule by innuendo; instil fear; but provide no feedback or positive guidance, so no-one actually knows what the FSA believe to be suitable or unsuitable. Even when they made positive remarks in the manual there was no explanation as to why they were likely to be beneficial to the client - though it was clear why the process was beneficial to the FSA monitoring process.

We have heard for the last decade, and specifically from Lord Turner, that the regulatory process was moving away from box ticking. Don't believe a word of it.

Just because someone says something loudly does not mean it is correct, or even that it has any validity.

In the case of the FSA they could get everything wrong and nobody would be any wiser because they do not have to explain themselves, or justify their conclusions. They are, in effect, an absolute power.

The paper on Allocation Tools was a make-work project, since it produced nothing of value other than fear.

"Bureaucrats write memoranda both because they appear to be busy when they are writing and because the memos, once written, immediately become proof that they were busy."

- Charles Peters

The Problem with Certainty

At University one of the Lecturers said that it was important to read novels - authors were the best sociologists of all. They saw what people did better than most and recorded it. They did not attempt to change it, merely to record it for the enlightenment of humanity.

Consider the depiction of the Civil Service in Yes, Minister. The Civil Service served the process, not the outcome. The outcome was too uncertain, out of their control. They were not in charge of policy, but the implementation of policy. Policy changes with each new minister, with each new administration. The only thing over which they could maintain some stability was the process, which therefore became their reason d'être.

In much the same way the FSA require certainty. Regulators require certainty. The market changes around them leaving them constantly out of their depth. The Bank of England learned to nudge, not to control. They understand that the economy cannot be controlled, but may be gently managed away from its wilder indulgences - generally. This lesson has been learnt through interact with the "real" world.

Although it is admittedly more painful, ordinary people do not deal in certainty. They intuitively know that the only constant is change. Some handle it badly, most cope admirably. Some use change brilliantly.

The FSA development a Group Think mentality that tied them into a fixed vision that was always out of date, and left them defending the often indefensible. But they were certain of their rightness, which left them out of touch with reality.

New Approach leaves this debate untouched. Since the FCA staff will be the same as the FSA staff the mind set will be identical. So, in practice, the problem of Certainty remains.

The Moral Minority

The FSA takes onto itself the absolute right to decide what is right and what is wrong within the financial industry, with out debate.

In the real world there are, in no particular order Catholics, Protestants, Muslims, Buddhists, Sikhs, Hindus etc. etc., and they will all argue from a different stand point, and often with a different conclusion, about the morality of an action.

Go to any University Library and there will be a whole section of books on Ethics.

In other words, in the real world, there is a wide difference of opinion.

But in finance the FSA is always right. In the legislation there is little option to question their decisions. They are even more infallible than the Pope.

If you have any doubts on this just look at the presentations to the Treasury Committee by members of the FSA. There is no question of discussion amendment or alteration. They are right and that is the end of the story.

Look at their rulings on Endowment Mortgages. There is a large amount of room for interpretation in respect of that outcome. Their initial comments many years back indicated that they could find little wrong. Then the whole process changed. They deemed the advice poor and yet more compensation. Yet it is difficult to understand their overall interpretation or the additional cost placed on insurance companies to rectify something that was totally unforeseeable, namely a dramatic change in the structure of returns during the 1990s and early 2000s.

It is not about whether the FSA are right or not. In many cases it is not possible to make such a judgment. It is about the fact that there is no possibility of dialogue on the judgment. And there is no cost to the FSA about being wrong.

If an individual makes a poor choice on investment that individual carries the cost. If an individual pays for buildings, content or motor insurance and never has the occasion to claim, the cost is that of the individual. If a person pays for life cover, and does not die during its duration the individual pays. Overall people pay for their choices one way or another, but they have the option.

If a political party decides on a course of action that proves to be poor, they will pay in the elections.

But the FSA pay for nothing. They are in no way held accountable for their actions or decisions. They are even in charge of raising their own budget, so they actually receive reward for acting ineptly.

[Why a non-accountable body can raise money without question in a democratic society is beyond me. It is counter to every precept of Rule of Law. Even parliament cannot do that. Utterly bizarre.]

This is the fundamental flaw in the structure of the existing and proposed legislation. They have an absolute level of power that is against all the conventions of parliamentary democracy.

There is nothing in New Approach that rectifies this. The process must be structural and must be practical or the FCA will continue down the same path of intellectual isolation that has put it on a path of moribund contention with the industry rather than dynamic development. One can judge the current sterility of the FSA's approach by the minute difference between the original RDR report and the implementation, despite the level of opposition. Does this sound like an organization that is in dialogue with the industry or one that is fixated on its own infallibility.

This can happen because the 2000 Act does not contain any explicit control processes. Despite some vague sounding sentiments neither does the New Approach (aka Same Again).

The FSA, who in personnel terms will be the FCA, have created an intransigent religion out regulation and are now on a moral crusade. Is this really the intention of the Government or Parliament? Or should the FCA's focus be one of stopping consumers being ripped of at the most economic level.

New Approach states that eh regulator should have "tailored objectives, functions and powers". Having made the statement it is impossible to see any development of these concepts in real, measurable, and controllable terms. It's flimflam for the consumer, who is, in practice is still left out in the cold.

A significant aspect of this weakness is that there is far too little factual information in the public domain upon which decisions for regulatory development can be made. Changes

are based on opinion and rhetoric, not facts. And facts are not just a string of numbers, they are solid information presented in an understandable context. For example, if there is a crash on a motorway there will be people to put the death into a perspective that motorways are still a very safe way to travel; similarly with aircraft crashes, it is still a safe way to travel. If one looks at the information emanating from the FSA and the FOS and turn it on its head, it would be possible to say that using an adviser is still a better way to plan one's finances than doing it oneself. All the figures indicate that 99% of transactions are perfectly acceptable.

Perhaps the system can be even better than that, but 100% is an impossibility.

I doubt that any one in the industry would argue against a process of continuing improvement, but should this not be on the back of encouragement not consistent criticism. The consumer sees this non stop criticism and assumes that the whole of the industry is rotten. It is not.

The tone of the criticism is set by the FSA and FOS painting the blackest picture in order to serve their own ends of never ending expansion.

There needs to be a separate, and independent body, that presents industry wide information a little like the Office for National Statistics. At the present time the FSA and advisers are arguing about the breakdowns and attributions within the current information. It should not be necessary to argue about these; the attention should be on what the breakdowns mean.

I can see nothing in New Approach that even looks in this direction. It really is Same Old Approach, New Hat.

The Four Areas of Regulation

I would suggest that there are four areas of "regulation" in financial services.

- Structural
- Wholesale
- Retail
- Enforcement

GM financial management

It is good to see the structural aspects moved to a structural entity, name the Band of England. Structural problems need a specific overview that is not part of the detailed work necessary in regulation.

It is bad to see the Enforcement left inside the regulatory body because again it requires a attitude that is not conducive to creative regulation. In the non-financial world the police and the law courts run under separate headings because there is a range of different specializations needed in both arms. Having them combines is universally seen as opening the door to too many problems.

But not in financial regulation? Why?

I would suggest that part of the problem with the current regulator is that they are too focused on finding the problems and have too little time for building on the good aspects that already exist.

I cannot support the concept of having an enforcement division inside the regulator. It is the wrong mind set. This would be like having the judiciary act as policemen. The current overcrowding of jails would be as nothing compared to what would happen if judges were both police and judge – though it may reduce the overall cost of running the judicial service!

I would also suggest that there is quite a difference in understanding between regulating providers and consumers.

Providers are medium to large producers of a commodity which they then sell through a middle man. Again the process is essentially structural, and, within limits, operates in a business logic. One is dealing with corporate structures.

The retail aspect has much less logic associated with it. As research shows people do not act and react in predictable ways. The process of regulation therefore needs to be very much more fluid in this area.

The Government has gone part of the way to recognizing that having these four regulatory areas under one rook does not work. I believe it has stopped short of completing the job.

Investment as Gambling

The investment industry is based more on sales than investment.

Investment managers do not make fortunes based directly on their performance, but rather on fees arising for the funds they manage.

Since the Big Bang the investment industry has exploded.

The amount of verbiage would fill a large hall, daily.

But is it actually about investing, or is it more about gambling.

There is a considerable body on research that calls into question the benefit of investment management. This does not mean there is no benefit, merely that overall the benefits are not a obvious as they should be.

Yet fortunes are made. Daily. Mainly by those who manage money. Playing on the greed and gullibility of the general public.

It is generally recognized that the majority of the population do not win in Betting shops - yet betting Shops do a roaring trade. Few people win on the Lottery. But it is extremely popular.

Overall people do like to gamble. Investment Management gives them a good story to make the process more acceptable.

The current vogue is Index Tracking. Why? Because it is cheap. Does is give better results? Debatable.

But actually is it investing. Again, debatable. Money is not going into companies, merely to structures that replicate the Index, which could be by mirroring the Index, or by purchasing derivatives to mirror the index. The later is probably the better mirror, because it is less costly to replicate the structural changes in the respective indices. But of course derivatives do not provide a dividend stream. And it is the dividend stream that Barclays Capital have shown is a major contributor to the long term performance of shares.

So, as Index Tracking is probably not investing, it must be gambling.

Yet the FSA are pushing advisers to recommend cheaper products. Not more cost effective just cheaper. Which on the above analysis could amount to moving investment strategies nearer to gambling than investing. I am sure the institutions are happy with this since the indications are that they can make significant amounts of money out of these new products,

The central problem is not whether the FSA are right or wrong, but whether their directives are appropriate for a Regulator. Where does regulation stop and interference

begin. The FSA are not experts at investment, investment products and their usage, but they are pretending to be.

There is nothing in New Approach that explains were these boundaries lie, or, more practically outline a process that allows for control of the Regulator. An institution that is unbounded is likely to develop in poor directions. We would all start to consider ourselves as geniuses but for the daily insistence of friends and colleagues that we are anything but. We have checks and balances that not only keep us within bounds of realism, but also allow, even encourage, us to grow in a productive manner.

New Approach provides no insight into the checks and balances that would apply to the FCA to keep it as Regulator rather than as the Right Hand of God, which is a problem that appears to afflict the FSA.

Caveat Emptor

Whether they admit it or not, the FSA regime is destroying the concept of Caveat Emptor, and by doing so is increasing the cost of regulation to unrealistic levels.

The concept of people being responsible for their own actions is embedded in the FSMA 2000, yet it is honoured more in the breach than the observance.

A recent example of this arose in February 2011. The circumstances, so far as they were reported are that Halifax issued mortgages, between September 2004 and September 2007, where the wording appears to have been confusing about whether a cap on its variable rate applied to particular mortgagees.

The compensation appears to relate to the Halifax's decision to increase the cap on its standard variable rate mortgage form 2% over BoE rat to 3% over.

Although there is no statement that what the Halifax did was wrong, they have still agreed to pay £500m in compensation, and expects to reimburse around 300,000 customers.

The curious point about this case is that there were very few complaints made, and the central point was picked up by the FSA when going though Halifax documentation. The mortgagees so not even have to apply for the compensation.

In other words something happened to the disadvantage of people holding Halifax mortgages that they did not consider of sufficient importance to raise a question on it. And not having raised a query they are still going to get compensation.

So why should these people, in future, be in away concerned about what financial instrument they should take out or buy. If something goes wrong, whether it is the providers fault or not, they just turn around and ask for compensation.

Is it the responsibility of the Regulator to reduce the need for individuals to take responsibility for their own actions.

In many ways this is a follow on from the Pension Review, were a significant proportion of claims arose because the PIA bombarded people with literature about claiming. I personally know of people who had no issue with the advice given, but, in the end, decided there was nothing to lose from making a complaint, given all the pressure on them to do so.

Is this really what a Regulator should be doing? Should there not be a process of debate. There is no such facility at the moment, and I can see no such facility for the future.

As the whole process costs money I would have assumed that a Government trying to control expenditure would have created a mechanism for verifying value for money decisions, rather than granting absolute powers.

A company in the private sector is judged on its economic performance, and is required to present sufficient information to allow others to make that judgement on a rational basis. It is to be hoped that the legislation will impose a similar requirement on the FCA, and that any judgements made can or will have a practical effect. Merely calling the FCA names if does a poor job is not sufficient incentive to ensure they do a quality job.

To Teach or To Learn

One of the main differences between Sixth Form and University (at least in my day) was that one was taught at school but learnt at University. The process of learning had to come on the foundation of that earlier teaching.

Current financial policy as implemented by the FSA therefore comes as a source of bewilderment.

We are told that the populace is financially illiterate. The FSA have talked about financial inclusion. We are in the middle of an economic recession that will make more people financially excluded.

Yet the FSA takes away access to financial advice to a section of society that could benefit from financial teaching; that can provide ground work for more of the population to understand what is going on.

By reducing the IFA population and moving it ever further up market that source of education is move further away from the people who can benefit most.

In 10 years the FSA did little to enhance the financial education of the populace, and rightly the job was taken away from them. Personally I doubt that it was ever an appropriate responsibility for a regulator. But it is bizarre to see that not only could they not promote education they are actively opposing it by their narrow minded approach to regulation.

Reinforcing the Bad

There is always a learning curve. The learning curve is improved by constant feed back, a process that Hector Sants in particular should know from his University Days.

Reinforcement enhances the good aspects and corrects the poor aspects.

Without quality feedback it is quite possible to end up with a total mess. And it seems that this is precisely were the FSA are headed - into a mess. And they will take a whole section of the financial industry with them, because there is no quality feedback, merely vague and unhelpful criticism.

There is very little consistency in process or judgements.

These deficiencies are not being addressed.

Every organization suffers from some problem. If those problems, deficiencies or inconsistencies are not acknowledged there can be no improvement. Quality feedback is essential.

If that had been happening over the last 10 years the market would not be in the mess it is today. Critical analysis is helpful; non stop carping criticism is not.

There must be some facility for this included in the legislation, or the industry will not improve. The FCA will merely grow bigger.

The Flaw in the Regulator

The flaw at the centre of the FSA is their need for certainty, for control. Unfortunately, like King Cnut, it is not possible to control, or have certainty, in the management of human affairs.

This flaw is not being controlled in the proposed legislation.

Indeed the process continues the evangelising crusade central to their current thought process. When a person buys a car they collated as much or as little information as they require, and make a decision, which they then live with. The same when they buy a house, or a television, or choose a holiday. The concept of caveat emptor remains.

Indeed this concept was central to the original Gower Enquiry, which observed that the level of supervision should not seek to "achieve the impossible task of protecting fools from their own folly… but should be no greater than is necessary to protect reasonable people from being made fools of."

I suggest that if more notice had been taken of that statement Regulation and the Financial Industry would be in a far healthier state, because the Regulatory regime would have been more flexible, and directed at more realistic and achievable targets. Trying to make any industry perfect is a gross waste of time and money. Whatever the FSA say about that objective, it is written in their every utterance. I suspect the Taliban have a more realistic approach to the world.

Regulation has now gone way beyond that, as can be observed in section 4.7 "… to ensure that the interest of retail customers are protected." Not, so that retail customers are in a position to protect themselves. They must be protected. This I would suggest is living Socialism. From a right wing administration. Amazing.

And the ultimate cost tends to be stagnation.

We are a free market economy because, overall, it presents the least worst option in that it allows and indeed encourages development, with the occasional major correction. Current Financial regulation does not encourage development. Merely fear of getting it wrong.

Indeed everything I see now is a process of preservation not development.

When they drew up their constitution the Americans ensured that it contained checks and balances. Because of that it has remained a relatively dynamic institution, though not without a degree of criticism. By contrast the Soviet system stagnated and declined.

I would suggest that a continuance of the current style of regulator regime is tantamount to following the Soviet model. There are no checks and balances in respect of regulation. It does not develop; it is merely more of the same.

Impartial Regulator (S4.9)

You say that the FCA will be an impartial regulator from whom firms and consumers can expect fair treatment.

What will cause this dramatic change in style and perception? There is certainly no one that I have come across in the financial world that considers the current regulator to be fair. Therefore this is a statement that will not be accepted at face value. Unless there is something installed in the legislation that allows advisers to protect themselves against the arbitrary rulings of the FCA the current level of mistrust will continue. In itself this is not a situation that will engender co-operation in the building of a quality system.

This woolly rhetoric can be found in the 2000 Act but no one believed is was ever followed through.

To my knowledge there was never any reference to the Director of Fair Trading, not was there a report from the Director under S160 and 161 FSMA 2000.

There is no practical process in place to trigger such a reference. Perhaps someone could have spent a lot on money trying to make a reference, but no one ever believed is was possible to make a case without massive, counter productive expenditure. Yet the number of participants in the insurance market has shrunk year on year; the cost of contracts has not diminish despite computerisation; the range of financial adviser has contracted rather than expanded (now Barclays have indicated they are withdrawing from advice - just like most of the insurance companies did many years ago); financial advice is becoming significantly more expensive, and tailored mainly for the rich. Does this sound as though there is good quality competition at play? What processes are going to be put into effect to ensure, not just hope, that is becomes an achievable target.

Impartial? Effective? Cost Effective? I doubt that you will get anyone on this side of the industry to agree to any of those suggestions as a description of the FSA. Why should the FCA be any different. It will be run by the same people running the FSA. It will have the same internal culture. One only has to watch "Yes, Minister" to understand that inevitability.

So what practical and effective processes is the new Act going to create in order to ensure that the current regulatory stagnation ceases.

I can see none in the current document. All I see is woolly statements that have less substance than the clouds overhead.

Summary of FCA Proposals

The fundamental problem is in the statement of problems.

Every objective sounds good. But as practical statements they hold as much content as the proverbial politicians promise at election time - try to nail down what it means.

A strategic objective to protect and enhance confidence in the UK financial system. Why?

The FCA is dealing with the internal UK market. At one level it doesn't matter if there is any confidence in the system or not.

Is there confidence in the UK Electricity market? The Gas market? The food market? In practice it is an irrelevant concept.

There may be annoyance at the price levels, the service, the availability. But confidence in the system? Bizarre concept, and because of that the FCA can play with the concept to their own advantage without anyone being able to question what they are doing.

The UK consumer will continue to save in the bank around the corner like Santander (Spanish), and buy life cover from Aviva (Global), and pensions from Scottish Equitable (Dutch/Global) whatever the level of confidence in the UK financial system.

Every time the market turns upwards so the level of investment rises. This is not about confidence, it is about good, honest, healthy greed. People want a return on their money. Simples.

So what are we maintaining confidence in? Perhaps the legislation could be more explicit about what this concept means and what Parliament expects it to mean. Remember the retail market operates inside the UK - it exports nothing.

The Wholesale market exports. This is the problem with having one body cover a range of options. The FCA are being carte blanche to impose irrelevant criteria across parts of the market, and increasing costs because of that.

And protecting consumers. Against what? Detriment? This is a fine new politically correct word. But does it have any genuine meaning?

Do we protect people against gambling, against crossing the road rashly, against climbing mountains in silly clothing. This is what people do. The best we can do it make it plain to people what the likely consequences of rash actions will be. We have been doing it for decades, if not hundreds of years. And does it stop people doing the ridiculous?

So what is it about financial products and advice that causes the government to create highly elaborate protection mechanisms?

By all means make literature clear; make consequences understandable.

But if someone bets on a horse, is there a fund to compensate for unforeseeable losses? I don't think so. If an investment manager makes an investment into a company that subsequently goes into free fall is there a compensation fund to prop up the fund price. I don't think so. If a person buys a house and circumstances change dramatically is there a fund to clear the negative equity. I don't think so.

These are all fairly familiar scenarios in which an individual will suffer detriment. Yet there is no (current) talk about the terrible consequences of detriment.

In general loss is part of life.

Until it comes to financial services and then something else takes over.

It is fine for a car salesman to earn an undisclosed level of remuneration of the sale of a car, that falls dramatically in value as soon as it levels the showroom. But that is all right.

It is fine for bankers to conduct merger deals on the basis of commission - even when there is significant evidence to show that very few such deals are beneficial to

shareholders - who therefore suffer detriment. But that is all right. There is no protective fund for that level of detriment.

So what is the guiding principle regarding the detriment in relation to consumers of financial products that makes it necessary to create a multi-million pound institution to protect them, and to create multi million pound funds to compensate them.

This is not questioning whether this is right or wrong (though I believe there should be some debate on the matter) but rather asking Parliament to define what it is the FCA is protecting. What specific aspect of consumer detriment requires this protection.

The report is silent on the matter. The FSMA 2000 is silent on the matter. The FSA have been vocal on the matter, but not definitive. Since they have a vested interest in developing the concept I would suggest that having them as sole arbiters of the concept is counter to natural justice. Since it is they who have created the concept I would raise the question about whether they are merely engaged in a job creation scheme.

We know what fraud is; we know what theft is; but what precisely is detriment, and how is it caused? How is it measured? What is its benchmark - perfection? Whose perfection?

The FSA have never defined the term, merely used it. The FSA have never indicated how they calculate the term, merely quoted unsubstantiated figures. Is this really the basis of quality legislation? I hope not, but fear it is.

There are so many questions raised by this section that it deserves a volume of analysis on its own.

Detriment

This is a concept used by the FSA to "demonstrate" the problems in the market. They have stated that detriment runs between £400m and £600m.

We have no information relating to definition, calculation, product, social category of consumer, time scale of contract and/or assessment or any of the other factors that would make the analysis understandable.

For example, is the advice to put money in a building society detrimental? Most accounts yield less than 1%, whilst inflation is at 4%. What is detriment?

The whole analysis is internally driven within the FSA, so there is no third party verification of the validity of the process.

There is no assessment of the base line beyond which it is improbable that detriment will fall further. In fact there is no proof that the current level of detriment is not at that minimum level.

There is no assessment of the level of market in each product to determine the level of the problem. Is it 10% or 1% or 0.00001%.

The FSA have given an estimate of the cost of RDR. That is in addition to the on-going cost of regulation. That on-going cost is not just the FSA and FOS. It also includes the compliance departments of every company operation gin the financial sector. The overall cost is probably in the billions.

There needs to be a requirement that all this information is placed in the public domain. If it is costing £4bn in order to save £600m in detriment, it may be cheaper to set aside £1bn each year to cover claims. That would still save the consumer £3bn. We actually have no real idea of the real level of the problem after 25 years of regulation.

Yet it detriment is a bed rock of the Retail Distribution Review.

There must be legislation to provide this information.

There must also be legislation to ensure that FCA estimates, costings and definitions have a basis in reality.

You have talked about the FCA maintaining market integrity. To do so they must be above reproach themselves, and the current consensus is the FSA come nowhere near to those standards.

The process of detriment could be a process of measuring the effectiveness of the FCA, but only if conducted by a credible third party.

What is the agreed current level; what is the agreed level in say 3 years time; what has been the cost of getting there; what has been the effect on the market of getting there.

Let the new legislation impose a very real requirement on the FCA to put meaningful and measurable information into the public arena. To date there has been no method of measuring the effectiveness of the FSA.

S4.18 Integrity in the System

Who defines the concept of integrity in the UK financial system?

Financial crime is relatively straightforward. Someone has broken the law, generally to enhance their own financial position at the expense of others. I am sure there are better and more comprehensive definitions.

But the section goes beyond that, in what can only be described as the usual vague innuendoes that characterise this document.

Ignoring the criminal aspect, there is an underlying assumption that the UK financial sector may lack integrity. If that is true I believe that there should be some working definitions of what constitutes integrity.

For example, the FSA have indicated that they can find no regulatory fault in the Bank of Scotland operation leading up to the collapse. So it is reasonable to assume that the business was conducted with integrity and incompetence.

I'm not entirely sure that the public would agree with this statement, or with the integrity of the subsequent distribution of bonuses. But the document is silent on what needs to be taken into account in determining integrity. If the FCA are to improve the integrity of the markets then there must be some specific process or objective.

Otherwise Parliament is merely saying we have this vague idea, so do what you want to do with it. And the FCA will be granted absolute powers to deal with matters as they wish.

It's a little like the concept of "bringing the sport into disrepute", which is used to quash any signs of dissent. The FSA have long had free reign to define matters as they wish, quite often retrospectively. I would suggest that this is bringing regulation in to disrepute, and definitely lacking in integrity.

Is Parliament genuinely happy with this?

S 2.107 Financial Stability

It is interesting that the FCA is included in the discussion on financial stability.

There is little or no question that this should be a topic directed at the macro level and wholesale institutions, but it is less obvious why it becomes relevant as the retail level.

If stability is addressed at the macro level that will feed down to the retail level. But what actions at the retail level would feed upwards to cause instability. Misselling life assurance, or ISAs or even pensions to individuals may cause irritation and upset, but, given the level at which this would occur, it would be a major miracle if it caused any serious financial instability.

Even the contraction of major insurance and assurance companies to a level of near monopoly has not created instability, though it may be causing distortion.

The legislation could again be providing a function that is unnecessary, but I would expect it to be used by the FCA to bolster their power base.

It would be wise to determine whether some of the functions under discussion are as important in real life as they are in debating chambers. If you still believe they are, what checks and balances do you intend to impose on their usage.

A major fault of the current system is that there are no checks and balances, which is why the FSA has ended up looking more like an institution to found in Soviet Russia than in a democratic society.

S2.94 Accountability on Rule Making

Its unbelievable how meaningless some of this language is. We'll tell people what's going on, but sometimes we'll also have to act.

There is so much drivel in this document that it is a hindrance to determining what is important and what is not.

If the legislation replicates this then the PRA, FPC & FCA are going to be able to take home bonuses to rival the bankers.

S2.94 Yet another section that is designed to pad out the document rather than say something intelligent.

Paraphrase: sometimes we'll do one thing, at other times another, and sometimes we'll have tea and biscuits while we talk about it.

S4.23 Regulatory Principles

All very laudable. All very vague. All contained in the FMSA 2000 Act and not one of them observed, implemented or even questioned.

Since the FCA will again operate in the structural manner of the FSA what bodies will operate to ensure that the FCA live by the strictures imposed by the Act.

Occasional questioning by the Treasury Committee is about as effective as a chocolate teapot. Can the Committee genuinely believe that they received anything other than a two fingered sign from the FSA in the recent meetings. The quality of factual information presented would have embarrassed a delinquent 5th former. There was no dialogue. The FSA said this is what we are doing and nothing it going to change us. That is not dialogue.

The FSA has said to the industry that this is what will happen, and nothing will change it. No dialogue.

The FSA are running the industry as though it were their own fiefdom.

Woolly principles do not provide a framework in which there can be a mutually beneficial working relationship. There needs to be a statement of the operational process. What targets are being set? How will they be measured? What penalties will the Directors of the FCA be subject to for failure to meet targets. That is what happens outside the rest of the financial services world - fail to hit targets, no bonus, dismissal, demotion.

S4.7 Protecting Confidence

S4.7 Is the perfect example of expressing an idea without actually saying anything meaningful.

There is no statement about what a successful outcome of retail regulation would or could look like.

If you are a good boy (girl) you will get to heaven. But what is meant by good? A concept that we have been debating for 10,000 years, and still do not have a definitive answer.

Yet we go down the same indefinable route for regulation. This is perfect for a regulator since it does not define the scope of their power or responsibility, and it allows them to define whatever they like as success and failure.

Surely the legislation should set some level of definition on this. But how can it, when the legislation itself is so woolly in intent. Perhaps this reflects the minds behind it.

S4.8 Let's try something else

An interesting paragraph built on an unproven assumption - large scale detriment. Implicit in this is the assumption that the detriment is far larger than should be tolerated.

Its a little like the football world. This manager didn't win the league for us so let's get another one.

The assumption that a regulatory authority could create the perfect advice system is rather ludicrous. But perhaps it could do better than it did. However, there is no information as to where the problems lie. Is it within the financial services industry or is it within the regulator itself?

There is no third party analysis - after 25 years of regulation, and 10 years of the FSA.

Surely it makes sense to have someone/something that is capable of making an assessment.

The current changes are based almost solely on opinions, not facts.

So no one has any real idea of why things need changing, or even if things need changing. Sometimes a process only requires a small adjustment to improve its performance and sometimes it requires a major overhaul. I am of the opinion that the current regulatory system needs an overhaul - but that is all this is, an opinion, because we are deprived of the facts and information that would allow a more detailed analysis.

I suppose the current position is even more curious. The government want a radical change - but wants to use the old legislation, with a few alterations. It's sort of pretending to be radical, but not too much. After all something that has been a shambles for 10 years can't be all bad.

S4.1 Good conduct

Section 4.1 is based on good middle class assumptions that exist more in the mind than in reality, and therefore distort the practical implementation of practical regulation.

In their own way these sentiments become as distorting as the extremes of religious sentiment, and as disfiguring. They are a condescending exposition of a mode of self righteousness. They could be considered to be insulting to a wide variety of peoples in the UK.

As people have demonstrated century after century they will climb into bed with anyone that can provide, or even merely promise, a decent level of return and/or security.

Regulation is there to provide a bedrock on which such transactions have a healthy level of realism. But they do not effect the willingness of people to enter into transactions they are not “kosher”.

To start from a misplaced preconception is to increase the likelihood that the path taken thereafter is erroneous.

“Good conduct of business” - as wishy washy a liberal concept as one could hope to come across. It expresses a sentiment, but explains nothing. Which, co-incidentally, is precisely the approach currently used by the FSA. [See the comment on Asset Allocation Tools] In other words there is a distinct probability that after all this nothing will have fundamentally changed in the rules or the process.

Section 4.2: precisely whose standards are we talking about in this paragraph. The more one reads of this document to more one gets the feeling that it was written by some middle class monks from a monastery in the middle of Herefordshire (I say monks, because I suspect if it had been written by Nuns the output would have been considerably more practical than ethereal).

S.4.4 Highlights the level of disjunction that is held by the writers between reality and fact. Insider dealing has been successfully prosecuted in the past, yet the FSA are being lionised for their recent successes in this field - after 10 years of existence. Rather than being lionised they should be castigated for such long term failure.

I doubt that anyone believes that insider dealing does not exist. I doubt that anyone seriously believes that it hasn’t been in play for the last 10 years. So why are the recent

successes now being headlined? This document should be about correcting the glaring faults and problems of the FSA over the last 10 years, not applauding their weak successes. But perhaps that tells us all we need to know about this document, namely that it is more likely to be flimflam than the basis of serious debate. As we see with every Government, serious debate is not on the table for debating.

If this Government genuinely believe that the FSA have been doing a sound job, why are they altering it? I suppose that the fact that the FMSA 2000 is being used as the backbone of the new legislation does say a lot.

So even though the FSA has presided over a multitude of regulatory problems in 10 years it is deemed to be success. So why are we being asked to comment on what appears to be a foregone conclusion?

Grabel's Law

"Two is not equal to three - even for very large values of two"

A brilliantly pithy statement of the obvious, and designed to counter those who refuse to accept basic truths. Somehow, if we fudge it long enough, perhaps we can made 2 equal 3.

And that, I believe, is what the FSA are doing with RDR. If they keep forcing their version of reality on the world, they believe they can cause that reality to be the right one.

Even though many people are telling them that their reality is flawed there is a determination to make 2 equal 3 and therefore vindicate themselves.

And now we are seeing the new Government take the same path. Let's change reality and pretend that the last 10 years has actually been quite good, excepting one or two minor hiccups - like Hector Sants refusing to acknowledge or understand the depth of the financial problem in 2008, or Equitable, or Northern Rock, or HBOS etc. They're all nice chaps though, aren't they.

If regulation is to succeed in the country it is critical that it is not based on the woolly concepts that pervade the FSMA 2000, or the woolly implementation of the regulatory system.

No Explicit Objectives

How do we establish whether the legislation and the FCA have been effective.

The FMSA 2000 set no objectives; there were numerous large failures in the financial services area between 2000 and 2010; yet the FSA is not called to account. In fact there is no mechanism by which they can be called to account. There are no criteria by which they can be called to account.

It is a little like saying we have had poor weather for the last 3 years so we are setting up an agency to "do something about it". What? Change the weather? Change our perceptions of the weather? Deal with some of the consequences of the weather?

And what is bad weather to me may be good weather to you.

Create such a Ministry and within a short time they will have created a substantial process, indeed one that requires ever more numbers to keep it functioning well. But at some time the question has to be asked - what benefit is it providing?

The same question should be asked about Regulation - what benefit does it provide, other than as a psychological blanket?

Despite the libraries of books on finance and related topics no-one has yet devise an algorithm that comes near to providing predictive capability. So we do not actually know whether anything written so far has genuine merit - we just work on the basis that it does, because we are need that comfort factor.

So the legislation is careful to shy away from rocking the boat.

An example is Box 1.A: Interim Financial Policy Committee

FPC will undertake … identifying systemic risks and considering action to address those risks. A wonderfully obscure statement of responsibility.

What is risk? No, don't define in a general descriptive way; it needs to be defined in a clear measurable fashion. That's were the problems start.

Risk in the UK or worldwide? Not stated. Yet a central aspect of the recent financial crisis was US home loan policy. Is the FCA required to address those risks. If so, how do we deal with China?

It takes 3 months to produce statistics to provide information on the state of the economy. These are "relatively" straightforward in that, after years of practice, the Statistics office has a process in place, and the information is well known, Yet is still has to be adjusted. So our information on the economy is between 3 and 6 months out of date. How much

more out of date is our knowledge of the financial economy? Do we actually know what state it is in at all? So how does the FCA address risks, that may have come and gone. Lehman's Bank collapsed inside 48 hours, apparently.

It is not that the sentiment expressed in Box 1.A is unworthy. It is merely that existing legislation is and future legislation is likely to be, so vague as to allow the Regulatory Authorities to write their own unquantifiable ticket.

Response by Andy Mullineux to Consultation on "A New Approach to Financial Regulation: building a stronger system" (February 2011)

1. As a pre-amble, please note that I failed to respond to the Consultation on the Bank Levy. I have just started a research project entitled: 'Taxing Banks Fairly', and in this connection I have read the IMF Report (June 2010) prepared for the G-20 on the tax contribution that might be expected from financial institutions, especially large banks (the Financial Stability Contribution (FSC) and the Financial Activities Tax (FAT)). In addition, I have read the Mirrlees Report (IFS, November 2010) on reforming the British tax system. It recommends extending VAT to financial services and is against turnover and transaction taxes (stamp duties and 'Tobin Taxes' broadly defined) even though, in my view, they might be used to discourage wasteful trading, 'churning' and 'short terminism' in financial markets.

   The IMF report stresses that financial (revenue raising, it should be noted) and regulator taxes' (capital and liquidity requirements) are potentially substitutes and complements and so an appropriate balance needs to be struck. This also has relevance in deciding how the supervision and depositor and wider investor protection insurance is to be funded (a subject of the current consultation, which I come back to). Hence taxation of banking and the wider financial sector needs to be considered alongside the proposals for financial sector regulatory reform considered here (and under the deliberation of the ICB).

   Financial Stability is perhaps an archetypical Public Good in the Economics sense (except perhaps that Hedge Funds thrive on volatility), that one person's or taxpayer's consumption of it does not diminish the amount to be enjoyed by another. But how should it be funded? What proportion should the beneficiary taxpayers pay for it and what portion in the banks (and other financial firms)? This is where the issue of taxing big banks that enjoy taxpayer insurance and the funding of supervision (as currently being considered in the US) comes in. How much should the taxpayer contribute, if anything? How much risk can be tolerated ('The Dutch Dyke' problem – it is too expensive (in terms of reduced lending growth perhaps) to eliminate the risk of crises). These are major Public Policy issues that set the context for the current and the related Bank Levy consultations.

2. A BBC briefing seems to imply (I have not checked) that following consultation long term bank borrowing (bonds?) should be deductable from the taxable liabilities under the levy. If true, this would be a mistake given the current resistance of senior bond holders to 'bail-ins' and 'haircuts' that aim to force them to share the cost of bank bail-outs with taxpayers. This would create an increased bias towards leveraging given that 'interest' on bonds is already deductable from corporation tax (and the Mirrlees Report does not recommend against this being a legitimate business expense, preferring to advocate equivalent deductibility for equity financing of all corporations, including banks). There may, however, be a case for eliminating deductibility of interest or bonds for banks to discourage leveraging. Deductibility from the Bank Levy liability should conformably be restricted to 'good bonds' ('covered bonds' and 'contingent convertible bonds') i.e. the tax system can be used

to encourage good behaviour (and raise more revenue). This is in line with the aim of the levy not just to raise revenue, but also to encourage shorter term bank funding from retail deposits and to discourage wholesale market dependency.

3. The IMF suggests extending VAT to the financial sector (and holds Australia up as an exemplar, whilst the Mirrlees Review lauds the New Zealand system). VAT on fee based financial services is relatively straight forward. VAT on interest margin based charging is problematic, requiring the use of hybrid systems and proxies. There are a number of options here. 'Free Banking' could be abolished. Banks could be required to charge fees (subject to VAT) for services provided and to pay interest that is market related (the income from which is taxable). The IMF also notes that the value added tax of a bank is broadly equivalent to profits plus bonuses and hence this, too could be taxed. Profit taxation is largely covered by corporation taxes (to the extent that banks are still liable to it in the next year or two given the losses stacked up during the crisis and charged against it), but there is still a strong case for taxing bonuses alongside the Bank Levy and this may have beneficial effects (increasing taxable salaries, reducing bonuses, increasing dividend payouts etc).

4. Turning to the consultation in hand, the case has already been made by the heads of the FRC and the London Stock Exchange for a separate regulation of the essentially international City based wholesale and capital markets (a UKSEC or UKSMA), which would fit well with the new EU regulatory and supervisory framework). There is a parallel case for a separate 'utility' supervisor of domestic retail financial (primarily banking and insurance) markets and products and services. If the ICB goes ahead with a proposal that retail banking should be done through separately capitalised subsidiaries, then this is the only arrangement that makes sense. The UKSMA would then regulate the City with an eye on the levelness of the international playing field achieving better international coordination (7.C). The utility regulator would concentrate on assuring retail customers are 'treated fairly' (and would take on the financial education role too, leaving the money advice network separate and containing the proliferation of 'Quangos'), and the competition authorities would be relieved of the heavy burden they have carried for since the 2000 Cruickshank Report. The utility regulator would naturally take over the consumer credit regulation from the OFT and regulate from retail payments systems.

   Hence, with regard to 5.A and 5.B, the proposed FPC should be abandoned in favour of a Consumer Products and Services (CPS) regulator and a UKSMA; which would need to co-ordinate with the PRA.

5. Turning to 5.K (and 6.A) and referring back to my 1) above, fees for supervision need to be set in relation to the (ideally risk-related) levy on banks (as advocated in the IMF Report) so that big banks compensate taxpayers for the insurance they provide to bank depositors, shareholders and bondholders. Smaller banks need merely contribute to a funded, deposit insurance scheme with risk related premia (as in the US). The FSCS should however be split into separate deposit insurance (DI) and consumer compensation schemes, with the DI Fund overseen by the micro prudential regulator (as in the US) so that it can guard against abuse of the insurance. 'Too big to fail' banks cannot be covered by such a scheme

and so it is debateable whether they should contribute to it. The government has chosen not to use the Bank Levy to fund a DI scheme for big banks because of moral hazard concerns. TBTF banks should either be broken up or 'breakupable' through 'living wills'/or 'special resolution regimes'. I doubt the latter will work in practice in the heat of a crisis, and breaking up will be politically hard to do and may undermine the City 'competitive advantage' in banking and finance (arguably achieved by regulatory competition dubbed 'principles based regulation with a light touch'). There should be a prudential fee (coordinated with the levy on (big) banks) and a separate consumer protection fee, though a (perhaps hybrid or proxy) VAT, as advocated by the Mirrlees Review, or a transactions ('Tobin') tax could be dedicated to this.

6. Money Advice Centre seems a silly name, as CFEB's role is financial education and raising financial capability, whereas as 'Money Advice' is commonly associated with debt counselling and banks, who bear at least some responsibility for irresponsible lending, should be expected to fund money advice, as it is in their interest to reduce default costs. They should also be expected to fund the more preventative activities of the utility regulator aimed at raising financial awareness and capability, so that the consumers can increasingly bear the responsibilities the proposed new legislation will thrust .upon them.

7. Given that the payments system is infrastructural in a modern society and financial exclusion persists, the utility regulator should impose a 'universal service obligation' on providers so that financial inclusion should become part of the mandate of the new regulating structure. Hence financial inclusion and access to finance should be part of its responsibility (which is not the case of the proposed FPC).

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